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STATE OF DELAWARE
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March 1, 2010

BY HAND

Ms. Alisa C. Bentley
Secretary
Delaware Public Service Commission
861 Silver Lake Boulevard, Suite 100
Cannon Building
Dover, DE 19904

RE: *In the Matter of the Application of Delmarva Power & Light Company for an Increase in Electric Base Rates and Miscellaneous Tariff Changes* (Filed September 18, 2009) – PSC Docket No. 09-414

In the Matter of the Application of Delmarva Power & Light Company for Approval of a Modified Fixed Variable Rate Design for Electric Rates (Filed June 25, 2009) – PSC Docket No. 09-276T

Dear Ms. Bentley:

I enclose an original and ten copies of the following pleadings for filing in the above-captioned case.

- **DIRECT TESTIMONY OF JOHN ANTONUK AND RANDALL VICKROY ON BEHALF OF THE COMMISSION STAFF – PUBLIC VERSION**
- **DIRECT TESTIMONY OF JOHN ANTONUK AND RANDALL VICKROY ON BEHALF OF THE COMMISSION STAFF – CONFIDENTIAL VERSION**

Copies of the public version of the testimony are being provided to all persons on the service list attached to the accompanying certificate of service electronically and by regular mail. Copies of the confidential version are being provided only to certain persons on the service list, as indicated on the certificate of service: the Hearing Examiner; Ms. Dillard; Ms. Iorii; Ms. Hall; and Messrs. Goodman, Kenton, Beck, VonSteuben and Janocha.

Please contact me should you have any questions about the filing.

Very truly yours,

J. Handlon

Joseph C. Handlon

Encs.
cc: Service List (attached; w/encs.)

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF DELMARVA POWER & LIGHT COMPANY FOR AN INCREASE IN ELECTRIC BASE RATES AND MISCELLANEOUS TARIFF CHANGES (FILED SEPTEMBER 18, 2009)	)	PSC DOCKET NO. 09-414
IN THE MATTER OF THE APPLICATION OF DELMARVA POWER & LIGHT COMPANY FOR APPROVAL OF A MODIFIED FIXED VARIABLE RATE DESIGN FOR ELECTRIC RATES (FILED JUNE 25, 2009)	)	PSC DOCKET NO. 09-276T

CERTIFICATE OF SERVICE

Joseph C. Handlon hereby certifies that, on March 1, 2010, he caused a copy of the **CONFIDENTIAL VERSION OF THE DIRECT TESTIMONY AND EXHIBITS OF JOHN ANTONUK AND RANDALL VICKROY** to be served upon the following persons on the attached service list by electronic mail and by hand:

Ruth Ann Price, Hearing Examiner

Janis L. Dillard, Deputy Director

Regina A. Iorii, Staff Counsel

Joseph C. Handlon further certifies that on March 1, 2010, he caused a copy of the **CONFIDENTIAL VERSION OF THE DIRECT TESTIMONY AND EXHIBITS OF JOHN ANTONUK AND RANDALL VICKROY** to be served upon the following persons on the attached service list by electronic mail and by regular mail at the addresses indicated thereon:

Todd L. Goodman, Esquire, Delmarva Power & Light counsel

Glenn C. Kenton, Delmarva Power & Light counsel

Heather H. Hall

Len Beck

W. Michael VonSteuben

Joseph F. Janocha

Joseph C. Handlon further certifies that on March 1, 2010, he caused a copy of the **PUBLIC VERSION OF THE DIRECT TESTIMONY AND EXHIBITS OF JOHN ANTONUK AND RANDALL VICKROY** to be served upon all persons on the attached service list by electronic mail and by regular mail at the addresses indicated thereon.

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Dated: March 1, 2010

SERVICE LIST--DOCKET NO. 09-414 and 09-276T (as of December 15, 2009)

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BEFORE THE
PUBLIC SERVICE COMMISSION
OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF DP&L POWER & LIGHT COMPANY FOR AN INCREASE IN ELECTRIC BASE RATES AND MISCELLANEOUS TARIFF CHANGES (FILED SEPTEMBER 18, 2009)	)))))	PSC DOCKET NO. 09-414
IN THE MATTER OF THE APPLICATION OF DP&L POWER & LIGHT COMPANY FOR APPROVAL OF A MODIFIED FIXED VARIABLE RATE DESIGN FOR ELECTRIC RATES (FILED JUNE 25, 2009)	)))))	PSC DOCKET NO. 09-276T

Direct Testimony and Exhibits of John Antonuk and Randall Vickroy

On Behalf of the Staff of the Delaware Public Service Commission

PUBLIC VERSION

March 1, 2010

Direct Testimony and Exhibits of
John Antonuk and Randall Vickroy

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Introduction and Qualifications

Q. Please state your names, business addresses, and positions.

A. My name is John Antonuk. I am president of The Liberty Consulting Group ("Liberty"). My name is Randall Vickroy. I am a senior Liberty consultant. Our Liberty business address is: The Liberty Consulting Group, 65 Main Street, P.O. Box 1237, Quentin, Pennsylvania 17083.

Q. HAVE YOU PREPARED SUMMARIES OF YOUR BACKGROUNDS AND QUALIFICATIONS?

A. Yes, they are provided in Exhibit LCG-1.

Q. MR. ANTONUK, PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE AS THEY RELATE TO THE SUBJECTS OF THIS TESTIMONY.

A. I began my career in the utility industry over thirty years ago. I served the Pennsylvania Public Utility Commission as an Assistant Counsel assigned to the General Counsel's Office. I then worked for a number of years as the head of the Facilities and Services Section of the Regulatory Affairs Department of Pennsylvania Power & Light Company, a major mid-Atlantic electric utility. I began consulting to the utility industry in 1981. I was one of Liberty's founders some 23 years ago, and have served as its president for most of that period. I am an honors graduate of Dickinson College and the Dickinson School of Law.

I have been directly responsible for managing Liberty's practice for utility regulators since it began shortly after the firm's founding. I have managed or directed several hundred projects in two thirds of U.S. jurisdictions and numerous jurisdictions in Canada involving dozens of electricity, natural gas, and telecommunications utilities. My work has addressed a very wide range of subjects, including areas such as governance, organization, staffing, executive management, planning, finance, rates, operations, budgeting, human resources, support services, compensation, and performance measurement. The contexts for addressing these subjects have included management and operations audits, merger and acquisition reviews, fuel and power purchase/sale and management examinations, affiliate audits, governance examinations, prudence reviews, fuel and energy adjustment clause audits and examinations, and rate proceedings.

Q. MR. VICKROY, PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE AS THEY RELATE TO THE SUBJECTS OF THIS TESTIMONY.

A. I spent 12 years with Public Service Company of Colorado, a major Mountain States electric and gas utility, starting as a financial analyst in the corporate finance and planning department, and then proceeding through the positions of financial supervisor, director of analysis, business development manager, and assistant to the chief financial officer. My responsibilities included financial planning, capital acquisition, capital spending analysis and allocation, treasury operations, securitization financing, project financing, mergers and acquisitions, cash management, and investor relations.

I have been consulting since 1991 on corporate finance issues in the electricity, natural gas, and telecommunications industries. During this time, I have provided consulting services to utility commissions and to companies in over 25 states and in three foreign countries. I received a Bachelor of Arts from Monmouth College with a major in business administration and a Masters of Business Administration degree from the University of Denver with an emphasis in finance.

Q. For whom are you appearing in this proceeding?

A. We are appearing on behalf of the Staff of the Delaware Public Service Commission ("Staff").

Q. What is the purpose of your testimony?

A. Our testimony addresses the need for assuring that the holding company, Pepco Holdings, Inc. ("PHI") and Delmarva Power & Light Company ("DP&L") have taken adequate steps to mitigate the risks imposed by the inherently weaker financial condition of non-utility affiliates and their operations on utility subsidiaries (in this case DP&L particularly). We also address a number of areas where this differential in financial condition has caused adverse cost effects that other witnesses addressing revenue requirements may consider. The remainder of this testimony is organized to address the following core principles:

1. Ring-fencing is not a new or novel concept; it arose years ago, not through utility regulatory actions, but out of the concerns of those engaged in the effects of holding company failures on debt repayment and bankruptcy risks for subsidiaries.
2. Ring-fencing seeks to mitigate the risks that non-utility operations impose on utility affiliates, and to assure that utility customers do not pay for the higher risks they bear when non-utility affiliates gain advantage through a pooling of risks, assets, or credit capacity.
3. Ring-fencing has demonstrated its effectiveness, as shown by the results of the Enron bankruptcy.
4. The financial and liquidity crisis of 2008 is the latest cause of renewed interest in risks that non-utility businesses impose on their utility affiliates.
5. PHI has not acknowledged the linkage between utility and non-utility risk, buts its actions show that it recognizes, and has taken actions to address, those risks.
6. The lack of adequate financial insulation has had direct consequence for DP&L generally, and as a result of the credit crisis of 2008.
7. Specific ring fencing insulation measures made part of a comprehensive, commission-required program would serve to insulate DP&L better; although they will not eliminate the risks of affiliation, they should substantially mitigate those risks.
8. Ring fencing measures do not increase utility customers' rates.
9. It is important that Delaware adopt measures designed to assure that voluntary methods do not lapse at times when they are most crucial.

1. The Origins of Ring Fencing

Q. Is ring-fencing a new or untested concept?

A. No. Ring fencing goes back as far as financial-industry asset securitization in the 1970s and 1980s. Securitization was designed to segregate and protect assets through special-purpose entities. The concept has been applied to utility holding companies for more than a decade. As we will discuss later in this testimony, the Oregon Public Utilities Commission ("PUC") included numerous ring-fencing conditions in its approval of Enron's acquisition of Portland General Electric ("PGE") in 1997. We began to observe the effects of affiliation as far back as our 1992 work for the New Jersey Board of Public Utilities, when we examined relationships and transactions among the state's largest energy utility, PSE&G, and its parent and affiliates. That was our first occasion to address the concept of holding company credit support to non-utility affiliates and the potential for negative impacts on the utility subsidiary.

Credit rating agencies have recognized and analyzed the effects of affiliation on credit strength for at least a decade. For example, in October 1999 Standard & Poor's issued a report ("Ring-Fencing a Subsidiary") stating: "Standard & Poor's takes the general position that the rating of an otherwise financially healthy, wholly owned subsidiary is constrained by the rating of its weaker parent." Standard and Poor's squarely identifies its concern with the holding company parent's ability and incentive to siphon assets out of its financially healthy subsidiaries (*i.e.*, the utilities) and burden them with the liabilities of poorly performing subsidiaries during times of financial stress. This "linkage effect" causes the ratings of all holding company family members, including the utilities that typically are the financially strongest members, to be linked with the holding company's consolidated rating. We have attached that report as Exhibit LCG-2.

Standard & Poor's has used a consolidated ratings method to reflect this linkage for many years. It analyzes the credit quality of all holding company entities as a group, which causes the credit quality of all affiliated entities to be affected by association with the holding company. The consolidated credit rating thus includes the risks and attributes of all holding company businesses, utility and unregulated. The consolidated rating is then either "notched up or down" for the debt ratings of individual companies, depending on the type of debt security issued, the holding company structure, and the ring fencing techniques in place to protect subsidiaries. Here, the subsidiaries of interest are PHI's utilities.

In summary, ring fencing did not originate in utility regulatory policy-making. Its origins lie in the concerns of those who rate and those who insure debt; in other words, it arose from the financial industry itself, not from utility regulators. It has been in existence for many years and it has been applied in the utility business for more than a decade.

2. The Goals of Ring Fencing

Q. What does ring fencing have to do with these effects on utility subsidiaries?

A. The "contagion" effect, which can cause distress at riskier enterprises to spread to stronger ones, is well-understood in the corporate finance community, especially for utility holding companies. The linkage effects can be lessened by specific protections formed to shield utility subsidiaries from the dangers of parent and affiliate financial distress or failure. These protections have come to be termed collectively as "ring fencing."

Q. Can you provide examples of risks that are not merely hypothetical?

A. Yes. History shows the risks to be very real and potentially catastrophic. Certainly not all or even most downgrades have been disastrous, but even more moderate ones should be of concern to utility management and regulators. Credit-rating linkage has affected regulated utilities on many occasions in the past 10 years. Several regulated utilities have suffered very large ratings downgrades since the late 1990s, due to association with distressed and in some cases failing non-utility business ventures. Some failed holding company diversification efforts involved participation in the merchant power, fuel, and energy-trading businesses.

The number of downgrades has been widespread. Fitch Ratings reported on an examination it undertook of its utility ratings actions by root cause for calendar years 2001 and 2002, and 2003 through October. This period corresponded to a very large number of ratings downgrades for regulated utilities whose non-utility affiliates or parents faced significant financial issues. Fitch found that holding company linkage was the single largest driver of rating changes (citing it as the reason for 51 percent of 83 utility ratings actions in 2002 and for 46 percent in the first ten months of 2003). Fitch explained that credit deterioration causing a non-utility wholesale energy merchant to experience rating downgrades led to concurrent downgrades to the parent and regulated utility affiliates. Such cases exhibit actual, negative consequence to utilities from linkage with non-utility affiliates. The document is attached as Exhibit LCG-3.

Another Fitch presentation reported on some particularly compelling examples of utility credit deterioration due to business reversals within holding company corporate families. From 2000 through September 2003, Fitch reported that Consumers Energy, Tampa Electric, and Carolina Power and Light each suffered downgrades of 3 ratings notches (which represents a whole rating category) due to affiliate contagion. Consumers Energy, for example, fell from a BBB rating to below investment grade, at BB. Fitch also noted that Northern States-Minnesota fell by four notches, Monongahela Power and Portland General by seven notches, and Indianapolis Power & Light by eight notches. Illinois Power fell by a stunning nine notches (from BBB+ to CCC+). Northwestern Corporation was driven into bankruptcy by failed HVAC businesses that dragged two utilities down with them.

Q. **What risks does such affiliation pose for utilities such as DP&L?**

A. Including DP&L in a holding company structure increases its risk of enduring severe financial distress should its parent or non-utility affiliates suffer significant financial reversals. Even in times of relative success by non-utility operations, affiliation causes DP&L to experience higher costs than it would absent affiliation. There are no financial benefits to DP&L through affiliation with riskier, non-utility businesses. DP&L can, however, benefit financially from affiliation with other utility operations in that they present more similar risk profiles.

Because affiliation with non-utility businesses provides no financial benefits to the utilities and because it imposes significant risks to them, it is important to structure DP&L's financing to insulate the utility from those risks and to avoid added costs due to those risks.

Q: **What is your view about the need for mitigation of the risks that affiliation poses for DP&L?**

PHI's financial structure must be changed to protect DP&L adequately against risks and costs that affiliation imposes. Some key protection measures already exist, but it is important to assure that their continuation is a matter of Commission requirement, not voluntary action. Otherwise, corporate policy changes or financial stress could imperil their continued existence. Moreover, as we will discuss, additional measures are required.

3. Ring Fencing's Proven Effectiveness

Q. **Can you provide a real-world example of the effectiveness of ring fencing??**

A. We believe that the case of PGE provides a compelling example of the effectiveness of ring fencing. In 1997, the Oregon PUC imposed ring fencing conditions on its approval of Enron's 1997 acquisition of PGE. Those conditions included, among a number of others, the following:

- Restricted any distribution from PGE to Enron that would cause its equity capital to fall below 48 percent of total capitalization
- Required PGE to maintain its own separate books and accounting systems
- Required PGE to maintain separate debt and preferred stock ratings
- Required PGE to maintain its own cash management system and finance its operations separately from Enron on both a short-term and long-term basis.

PGE also maintained separate utility management, who remained responsible for the day-to-day operations of the utility.

These ring fencing protections helped to shield PGE from Enron's collapse and subsequent bankruptcy filing, and also worked to safeguard its cash and assets. In contrast, two other Enron subsidiaries, Transwestern Pipeline and Northern Natural Gas, pledged assets as collateral for loans and passed the funds to Enron just before its collapse. Enron was unable to similarly borrow money from PGE, illustrating the effectiveness of its financial management insulation.

In addition, after Enron declared bankruptcy, PGE issued to an independent shareholder a "golden share" of a new, special class of junior preferred stock that limited PGE's right to commence a voluntary bankruptcy. This special class of preferred stock requires the vote of the junior preferred holder before the utility can voluntarily file for bankruptcy. PGE also provided a "nonconsolidation" legal opinion to the effect that a bankruptcy court would not consolidate PGE with Enron.

Even with the best existing insulation, contagion and the linkage to a bankrupt parent can still occur. "Perfect" insulation is impossible to construct. The measures did not avoid all harm; PGE's Fitch credit rating still dropped seven rating notches, from A+ to BB. But Enron's credit rating dropped much more; it fell 16 notches, putting it into the default category.

4. The Financial Crisis of 2008 and its Implications for Ring Fencing

Q. What are your observations about how utility insulation has waxed and waned as an issue of regulatory focus?

A. Interest in ring fencing protections has tended to increase during periods when utility holding company diversification efforts have gone sour, and caused obvious financial damage. The 2000-2004 period was especially problematic in terms of damage to utility companies. We recall that the topic arose often in industry forums and conferences, regulatory meetings, and rating agency presentations as this period progressed. Discussion of the problems of damaging contagion from holding companies and unregulated affiliates affecting utilities did not, however, lead to widespread efforts to put actual ring fencing protections in place.

Fitch has noted that "PUCs often seem to become more active in exercising authority when credit quality falls below investment grade and after the company's financial integrity has already been impaired." We have attached the underlying Fitch document as Exhibit LCG-4. It is in our view critical to keep in mind that risks remain even when non-utility performance is better. One cannot accurately predict exactly where or when the next non-utility reversal is coming, but experience has taught us that their frequency and severity are high enough to create continuing concern. Moreover, the volatility that energy markets have exhibited teaches us that risks not only remain, but their consequences can become much greater. Therefore, we consider ring fencing provisions to be important tools for commissions to use in protecting the interests of utilities and their customers on an ongoing basis, independent of known difficulties.

Q. Describe your understanding of the liquidity issue affecting energy market participants and how events in 2008 affected those participants.

A. As market prices change, the value of existing energy contracts change correspondingly. For example, an energy company that has a contract to receive electricity at a certain price experiences a decline in its contract value if market electricity prices decrease. Standard industry contracts call for such a change in contract value to be paid to the seller in the form of cash collateral. In addition, margin requirement changes for exchange-traded contracts can also cause a demand for posting additional collateral with the exchange. The rapid changes in 2008 energy prices put financial and liquidity pressures on many energy market participants. Those with large merchant energy operations and energy trading operations felt these pressures particularly.

A number of companies in the energy production and trading businesses experienced extraordinarily large liquidity-maintenance needs during 2008. These needs were much influenced by the combination of extremely volatile energy prices and standard contractual agreements requiring cash collateral when market prices changed. In the first six months of 2008, energy markets saw increases of about one-third in power prices, nearly half in natural gas prices, somewhat over half in crude oil, and a staggering 1.5 times in coal. Then, prices moved sharply in the other direction in the second half of 2008, retreating sharply from mid-year peaks. Gas prices, for example, moved from around $13/MCF to near $6/MCF within a few months.

Q. Is there a concrete example of how the liquidity issue affected energy market participants and how events in 2008 affected those participants?

A. Yes. As is now well known, the swings in energy prices, related collateral requirements, and credit-rating pressure effectively forced an agreement to sell Constellation Energy to Warren Buffett's MidAmerican Energy in September 2008, which corresponds generally to the timing of the severe liquidity problems that brought DP&L before the Commission seeking expedited treatment for its $250 million debt issuance. Constellation's 2008 Proxy Statement provides a sobering account of how utilities can become involved suddenly and overwhelmingly in the problems of their energy affiliates.

Constellation was one of the largest U.S. energy marketers and traders. It had potentially huge collateral posting requirements as energy prices changed. In the event of a two-notch credit rating downgrade, Constellation would have been required to post additional collateral of approximately $3.33 billion, calculated as of August 31, 2008. However, as of that date, it had only net available liquidity of $1.57 billion. The three credit rating agencies were in constant contact with Constellation regarding its severe liquidity issues. Standard & Poor's and Moody's advised that both an injection of $1 billion of equity capital and an additional $2 billion line of credit would be immediately required to avoid multiple-notch ratings downgrades. Constellation management believed that the ratings downgrades would cause the resulting cash collateral requirements to exceed $3 billion, making the company insolvent and forcing it into bankruptcy.

The company attempted to line up additional bank lines of credit and substantial equity capital to support its credit rating. But at this time, capital markets were experiencing a severe credit crunch. The financial crisis would become worse with the collapse of Lehman Brothers on September 15. Ultimately, MidAmerican agreed to make an immediate preferred stock investment of $1 billion, and to buy Constellation for $26.50 per share in an all-cash merger. Thus, the liquidity crisis caused by Constellation's trading operations forced the sale of the holding company at a bargain price.

Q. Are you equating the financial conditions that caused the sale of Constellation with that of PHI?

A. No. The dollar magnitude of the liquidity shortfalls at PHI was significantly less than that of Constellation, and PHI was able to resolve its issues without selling the company. On the other hand, the causes of Constellation's problems were similar; *i.e.*, liquidity requirements for collateral calls in the energy trading and merchant energy businesses that occurred due to energy market changes in the second half of 2008. The relevant point here is that a holding company in the same businesses as PHI with the same type of liquidity issues was in danger of becoming insolvent, which demonstrates how serious affiliate liquidity risks can be.

Q. **How did the energy market volatility of 2008 affect PHI and its liquidity requirements?**

A. The retail marketing and trading businesses of Pepco Energy Service, Inc. ("PES") and the wholesale generation and trading activities of Conectiv Energy Holdings, Inc. ("CEH") triggered a 2008PHI-level liquidity crisis, which required additional and immediate access to liquidity sources and the capital markets to ensure sources were available in the amounts required by the rating agencies. If PHI's crisis was not as severe as Constellation's, it is not because greater protections against it were in place, nor does it demonstrate that concern about future risks should be less. PHI's problems were real and severe.

Q. **Please explain the rating agency liquidity requirements and how they are calculated.**

A. S&P requires the utility holding companies that it rates to perform a liquidity survey on a quarterly basis. The S&P surveys are commonly referred to as liquidity "stress tests." They are not published. S&P is the most formal and explicit of the rating agencies about requirements in this area. This rating agency focuses on adequate liquidity for utility holding companies extends back a number of years. The S&P liquidity survey requires companies to list consolidated unrestricted cash assets, amounts available under committed credit facilities, posted trade collateral and the market value of excess or discretionary fuel inventories as their primary liquidity sources.

S&P compares consolidated liquidity sources to potential liquidity requirements under two stressful scenarios to test their adequacy. The first stress test is for cash requirements, or "liquidity calls," in the case of a credit event. A holding company's credit rating falling below investment grade at one of the rating agencies, such as was threatened at Constellation, would comprise such an event. The second and more severe stress test adds to the credit event scenario the negative mark-to-market impacts of either a 15 percent market price increase or decrease in the next year, and a 20 percent increase or decrease in the second forward year.

When conducting this test for PHI, S&P includes all PHI liquidity sources, including utility cash and credit capacity. In other words, liquidity at the utility level, whether or not the utilities themselves require it, is considered as a source of liquidity support for the consolidated enterprise, which includes non-utility businesses. The incremental liquidity requirements measured in the stress scenarios were not due to the utilities, but were caused solely by PES and CEH operations. It is worthwhile to observe here not only that there was a major utility contribution to solving liquidity problems, but also that what caused problems under the S&P stress test results. In other words, while serving as a solution, the utilities did not cause the problem.

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5. PHI's Acknowledgement of Risk Linkage

Q. Does PHI acknowledge that PHI's non-utility businesses adversely affect utility finances?

A. It appears that PHI has not acknowledged that PHI's unrelated business have an effect on DP&L's finances. PHI Senior Vice President and Chief Financial Officer told the Commission on November 19, 2009, "And I can also say that I have been dealing with the rating agencies for years and years and years. We meet with them formally once a year. We probably talk to them every quarter. And I have never had them tell me, and I have asked them this question, if we did not have our unregulated subsidiaries, would that increase the rating of our utilities and have them say, Oh, yes. That just doesn't happen. They rate the utilities based upon the financial measures of the utilities." (Docket No. 09-371, November 19, 2009 Transcript at 53).

Q. How does this statement comport with what you know about ratings generally and have learned about PHI and DP&L specifically?

A. We cannot rationalize it with many years of communications by "rating agencies" that have a long tradition of analyzing and reporting on the debt of companies like PHI and DP&L. In fact, their documented communications lead one to conclude that affiliation has a negative effect on utility ratings. This is not true only as a general matter, but applies specifically to DP&L.

Q. What specific risks are acknowledged by the rating agencies for a utility such as DP&L in its current utility holding company structure?

A. S&P's credit rating reports for DP&L summarize certain risks that holding company affiliation places on the utility entity and its customers. S&P's August 12, 2008 report on DP&L (provided as Exhibit LCG-5) expresses views consistently appearing in its DP&L credit rating reports since at least 2006, the earliest of the reports that we reviewed:

> *We consider the unregulated businesses significantly more risky than the utilities due to their exposure to volatile commodity prices and very competitive retail energy markets. These risks are partly mitigated by the company's strategy to hedge a majority of its capacity over a two to three year period. PHI has reduced the risk profile of its unregulated financial services operation by selling many of PCI's non-energy investments, but the business remains exposed to IRS challenges regarding the tax-deductibility of SILO transactions.*
> *... The ratings incorporate a consolidated financial profile that we consider as aggressive.*

S&P makes it clear that it bases the DP&L ratings on the *consolidated* rating of the PHI holding company, including the utility and non-utility businesses. They do not simply "rate the utilities based upon the financial measures of the utilities." S&P also lists the major rating factors that comprise strengths or weaknesses for each company. Two of the three rating weaknesses S&P's identifies for DP&L comprise risks that actually arise outside the utility and from affiliation: (a) "Riskier unregulated operations comprise over one-third of consolidated cash flow," and (b) "Contingent liabilities associated with IRS challenge related to sale-in lease-out (SILO) transactions."

Q. Has S&P addressed specifically the issue of liquidity, which you discussed with the Commission in November 2008 in connection with DP&L's $250 million debt issuance, as a risk?

A. Yes. It did so specifically in connection with actions taken to mitigate the liquidity risks that we believe laid the foundation for PHI's need for external financing at that time. Because S&P's report came after PHI took actions to "cure" the liquidity problems, S&P's observation about the "problem" must therefore be gleaned from its discussion of the problem's solution. S&P added the following passage to its DP&L reports in 2009. The August 2009 DP&L rating report states:

> *The operations of CEH and PES can expose the consolidated entity to unpredictable and greater than expected collateral calls. The (Morgan Stanley) credit intermediation agreement helped free up availability under the credit facilities after reductions in outstanding LCs (letters of credit).* ***More recently, the company has maintained sufficient liquidity*** *to address potential collateral calls under a stressed scenario comprised of a negative credit event and an adverse movement in commodity prices.* [emphasis added]

S&P's 2009 guidance also notes that the PES strategy is shifting away from retail energy supply to contracting services, and that PHI was conducting a strategic review of the energy supply operation and reducing collateral obligations. The full DP&L credit report as of August 6, 2009 is attached as Exhibit LCG-6.

The S&P views expressed in 2009 reflect a sound PHI action to address the liquidity concerns. Continuation of a more cautious approach to liquidity, if it assigns the costs of doing so properly among affiliates, will benefit Delaware utility customers. On the other hand, the actions came in response to severe distress and not in anticipation of it, thus making mitigation and not avoidance the focus. Moreover, there still remain the key questions we will address regarding money pooling and the sharing of credit capacity at PHI.

Q. What are the DP&L ratings versus those of PHI?

A. The S&P corporate credit ratings for PHI and its subsidiaries are based on the consolidated business and financial risk profile, which includes the utility and non-utility operating units. DPL's BBB corporate credit rating is the same as the parent's rating. The parent's senior unsecured debt obligations are rated one notch lower than the consolidated corporate credit rating. This differential recognizes the structural subordination of holding company debt to that issued at PHI's operating utilities. This method recognizes that the credit strength of the holding company is derived predominantly from the utilities. DP&L's senior unsecured rating of BBB is the same as the consolidated credit rating, showing no "notching separation."

Both DP&L's S&P corporate credit rating and senior unsecured rating have actually been the same as that of PHI over most of the past several years. Standard and Poor's June 29, 2009 report rates the corporate credit for PHI and DP&L the same, at BBB. Moody's assigns an issuer rating of Baa3 to PHI and Baa2 to DP&L. Fitch's current long-term "issuer default rating" is BBB for PHI and BBB+ for DP&L.

Moody's and Fitch do not use the same consolidating ratings approach as Standard and Poor's. Each gives a DP&L rating that is one-notch higher on the corporate rating; Fitch rates DP&L two notches higher for senior unsecured debt. Standard and Poor's has generally not applied "one-up notching" for DP&L, implying more linkage and minimal separation between the holding company and the utility.

Q. What ratings differential might effective ring-fencing produce?

A. The objective of ring fencing is to provide the utility with appropriate insulation so that it may be rated on a "stand-alone" basis as much as possible. According to S&P, strong ring fencing should result in separation from the parent of three rating notches above the parent, or one full rating category.

Q. The Company has noted that Moody's upgraded DP&Ls senior secured debt recently; what was the reason for this upgrade?

A. The upgrade was not related to the credit profile of DP&L or any other individual issuer. Moody's globally upgraded $91 billion of the senior secured debt ratings of investment grade regulated utilities by one rating notch on August 3, 2009, including DP&L. The ratings action widens the notching between most senior secured debt ratings and senior unsecured debt ratings of investment grade regulated utilities to two notches from one previously, based on updated analysis of the default differences between the security classes.

Q. In discussing the risks that affect credit ratings, you have addressed energy market issues; did you observe other particular areas of non-utility risk at PHI?

A. PHI maintains a portfolio of eight cross-border energy lease investments. Their equity value at December 31, 2008 was about $1.3 billion. PHI has been involved in a tax dispute with the IRS regarding the tax benefits from these leases ($488 million) from 2001 through June 30, 2009. PHI took a charge of $124 million in 2008 to mark down the equity value of the leases. If the IRS prevails in this dispute, PHI would be subject to additional taxes, interest, possible penalties, and may also eventually have to write down the value of the leases.

While consequential, this is not a new risk, nor is it one that PHI has been enlarging through continued activity in this area of operation. It now represents a risk that is therefore known and reasonably "capped." It does, however, show that not all risks posed to utilities from affiliation arise from energy market volatility. It also shows that ring fencing remains important even should the last publicly visible risk have been addressed. Particular risks can be fluid in magnitude, type, and source as a holding company enters new businesses or as existing businesses face new uncertainties.

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Q. When were the "management plan" financings announced and settled?

A. The parent announced an equity issuance of 14 million shares for about $225 million at the time of the financing hearing in Delaware; the issuance settled on November 12, 2008. A new, 364 day $400 million PHI credit facility closed on November 7. The

DP&L, ACE, and PEPCO $250 million bond issuances settled on November 14, November 25, and December 10, respectively. The utility construction reductions were increased to $18-$20 million for the remainder of 2008 and $180-$200 million in 2009. A March 27, 2009 PHI Analyst's Conference summarized these, among other, actions. The slide used at that conference to do so is attached as Exhibit LCG-7. These announcements make clear how the non-utility liquidity crisis affected not only utility debt, but compromised DP&L's operations as well.

Q. How were the five transactions – parent equity issuance, parent credit facility and the three $250 million utility bond deals - related to each other?

A. They were all part of a financing package deemed necessary to meet liquidity needs and to mitigate the potential for a disastrous credit downgrade. [redacted] It seems clear that PHI was acting directly in response to the fear of imminent credit downgrades should liquidity not be improved very significantly and immediately.

[redacted]

Q. Has PHI or DP&L acknowledged that the utility financings were accelerated to resolve a liquidity crisis caused by PES and CEH?

A. They certainly did not acknowledge this fact in the Delmarva financing proceeding in early November, 2008. However, PHI stated at the March 27, 2009 analyst conference that, "We anticipated and managed the challenges" and that they "Accelerated the issuance of $750 million of first mortgage bonds and $225 million of equity to the fourth quarter of last year." PHI has also taken credit for reducing power delivery (*i.e.*, utility) construction spending in 2008, 2009 and 2010 by $129 million, $229 million, and $178 million, respectively.

Q. Did the $1.4 billion of cash and new credit capacity fully resolve the PHI liquidity crisis?

[redacted]

Q. Did the financing package improve PHI's consolidated stress test ratios?

A. [redacted]

Q. How did the Morgan Stanley agreement affect PHI liquidity?

A. The Morgan Stanley credit intermediation arrangement significantly reduced PES' potential collateral requirements by about 32 percent as of June 30, 2009. Morgan Stanley agreed to assume wholesale purchase obligations of PES and provide the energy to PES under the same terms, but without any associated collateral obligations. The Company has reported that this agreement came at a cost of $25 million. In addition, PHI has announced that PES will exit the retail energy supply business. PES has been the source of large collateral requirements and a major contributor to recent liquidity problems.

Q. Were these responses appropriate?

A. Yes. We credit the Company for taking them. However, as we discuss later, in protecting the interests of utility customers, it is not sufficient to rely upon after-the-fact corrective actions alone.

6. Cost Consequences to DP&L from Affiliation Generally and the 2008 Crisis Specifically

Q. What do you believe is the best way to measure the impact of affiliation on the DP&L credit ratings?

A. As noted elsewhere in our testimony, PHI's and DP&L's corporate credit ratings are each BBB. DP&L's senior unsecured debt is rated the same as PHI's consolidated corporate credit rating, implying minimal protection for the DP&L debt holders from the risks of the holding company and its unregulated utilities. Ring fencing would provide "separation" between the DP&L unsecured debt and the consolidated credit rating of up to a full rating category, according to S&P. The inability to totally eliminate holding company linkage is a prime reason that the separation would not be higher.

A second constraint on the potential upward movement of DP&L's credit rating is that its stand-alone financial metrics do not support the "A" rating that is one full rating class above the parent; they may not support an A- rating either. For these reasons, we believe that a conservative measure of the negative effects of affiliation is currently one credit notch, from BBB+ to BBB. We have provided this opinion to Staff witness Rothschild for his consideration of its impact on DP&L's cost of debt.

Q. What do you believe were the consequences of issuing the $250 million in DP&L debt in late 2008?

A. As we have previously noted, DP&L's $250 million first mortgage bonds were issued during catastrophic capital market conditions that stand among history's severest. We believe that appropriately utility-focused management would have sought to avoid issuing longer-term debt in this market, if at all possible, to avoid locking in higher interest rates for an extended period. DP&L did have significant levels of short-term debt that indicated the need for replacement with long-term debt, but we believe this condition resulted from maintaining inadequate utility flexibility. DPL had $150 million of credit facility borrowings at October 28, 2008; about $85 million of this amount arose from having to pay back the money pool. The Company reported at this time that only "about $40 million" was still available to the utilities under the 3-company sub-limit of $625 million, which became an important constraining factor. Given DP&L's $500 million commercial paper program, DP&L required access to up to $500 million of the credit facility. If DP&L had retained full use of the amounts contemplated by the credit facility, responsible financial management would have continued with the issuance at its own planned date, which we understood to be during the first half of 2009, or even perhaps delayed it longer. We have advised Staff witness. Rothschild that, without holding company pressure to issue $250 million of debt in November 2008, DP&L would not have issued before the first quarter of 2009.

Q. How did DP&L's actions in the fall of 2008 correspond with what you would expect to see in terms of balancing short-term and long-term debt?

A. Instead of using long-term debt to comprise a more representative portion of its capital structure prior to the fall of 2008, (similar to what DP&L has proposed in this rate proceeding for example), PHI allowed the utility to rely on short-term debt, which was cheaper than long-term debt, for a long period. When short-term debt is cheaper than long-term-debt, a utility can gain the opportunity to arbitrage the difference in rates. This arbitrage results when customers are paying rates based on higher percentages of long-term debt than a utility actually uses, when it discovers market opportunities to use cheaper short-term debt. This effect can increase the utility's rate of return and decrease its regulatory revenue deficiency. In the case of a utility that, like DP&L, has a comparatively large capital program, short-term debt tends to grow until it reaches levels that are large enough to make long-term debt issuances right-sized for market conditions. DP&L's 2008 financing plan included a long-term debt issuance of $150 million. A combination of issuance size, short-term credit capacity and market timing (*e.g.*, deferring issuances somewhat in distressed markets where spreads against treasuries on utility issuances are at comparatively high levels) are among the factors that go into determining when to roll short-term into long-term debt.

Q. How can the increased reliance on short-term debt affect customers?

A. Increasing the use of short-term debt when it is cheaper benefits shareholders in the short run because it lowers costs relative to prices. It does not affect customers in the short-term, if prices are not reset until a following rate case. Similarly, if short-term rates rise, that will harm shareholders without affecting customers. Thus, in the immediate term, there is no customer impact. However, the timing of the roll-over to long-term debt can have consequences at the next resetting of base rates. If, for example, a long-term issuance is delayed for three months in order to continue to use cheaper short-term debt, the eventual issuance of that long-term debt will be at higher rates than it would have been if rates go up during the three-month delay period, or at lower rates if the market for such instruments falls.

It is not our belief that utilities should "speculate" on basic market directional moves in timing long-term debt issuances. It is, however, prudent to retain enough flexibility and capacity to avoid having to enter the market at times of particular distress. We do believe that utilities should not press the use of short-term debt so far as to foreclose options for dealing with financial contingencies. The contingencies they face should be only their own. DP&L's case was complicated by being involved with the contingencies faced by its non-utility affiliates.

Q. What do you mean by displacement in this context?

A. The use of a money pool in which DP&L and non-utility affiliates participate is a source of such displacement. DP&L regularly borrowed from a pool that contains money deposited or invested primarily by PHI. DP&L is subject to the potential need to replace its money pool borrowings with other sources in large amounts and with little notice from holding company management. Money pool funds previously loaned to DP&L may then be loaned to PES or CES if they have an urgent need, as they did in September and October 2008. These decisions are made by holding company managers, not DP&L.

In describing this phenomenon of displacement, however, we do not want to imply that there are not other problems with money pools. For example, we consider the ability of non-utility subsidiaries to borrow funds contributed by utility affiliates to be an even more serious problem.

Displacement happened to DP&L in the fall of 2008, when the usual pattern of growing utility borrowing from the money pool reversed itself as the non-utility affiliates found themselves in an expanding liquidity "crunch." DP&L borrowed from the money pool from September 2007 through February 2008, and then continued to do so in increasing amounts from June through September 2008, reaching $85.1 million at September 30, 2008. DP&L's borrowing from the money pool was eliminated entirely in October 2008, at the same time that the PES and CEH borrowings from the money pool increased by about $211 million. Thus, DP&L got displaced in the sense that the utility, and not the non-utility affiliates, was forced to find short-term loans from other sources when the cash needs for the non-utility affiliates increased.

Q. What is your position on multiple utility pooling of cash and debt?

A. Theoretically, we can imagine cases where utilities face such widely varying risks that pooling their resources may be deemed problematic. However, to the extent their risks are similar, we see pooling among utility operations (with effective protections) as an effective cash management method. We are also not opposed to forms of utility-only common long-term debt issuances, provided that they prove economical and consistent with existing utility mortgages.

Q. Are there other "displacement" risks to consider?

A. Let us first note that, for the reasons we identified above, a common credit line involving utilities and affiliates should always be avoided. However, recognizing that PHI decided otherwise here, the way PHI constructed it was even more problematic. When a common credit line (such as PHI's $1.5 billion one) is used, it is essential that it be sufficient to create a large enough facility to meet utility needs and that it have firm, inviolate sublimits on portions available only for utility use. Otherwise, non-utility borrowings can "crowd out" utility borrowings.

Q. Does PHI apply such sublimits?

A. PHI has a sub-limit of $875 million and the three utilities a total of $625 million under the $1.5 billion credit facility. PHI has the option to request increases in the total credit facility of up to $500 million. Any such credit capacity increase may be allocated "as directed by PHI," but the base PHI sublimit of $875 million cannot exceed $1.25 billion following any such total facility size increase. PHI therefore has the option to allocate all of any credit facility increase to the parent and none to the utilities, up to a revised maximum PHI sublimit of $1.25 billion. However, exercising this option would re-open the pricing mechanism, which PHI found to be too expensive during the credit crisis.

Q. How did changes in access to the commercial paper markets affect DP&L in late 2008?

A. DP&L has reported that those markets were closed to them by the time of its requested expedited treatment of its $250 million debt issuance request in November 2008. However, the reason that credit facilities are required to back fully a commercial paper program is to provide liquidity in precisely this type of situation; *i.e.*, when the commercial paper markets are closed. PHI cannot claim that the closure of the commercial paper market alone caused DP&L to issue long-term debt. DP&L should have had available a back-up credit facility equal to the size of its $500 million commercial paper program. DP&L obviously did not have it under the $1.5 billion credit facility in the fall of 2008. Moreover, PHI did not arrange for it otherwise either. We certainly do not consider the general economic circumstances that led to the closure of that market to DP&L to have been foreseeable. However, the removal of money pool capacity and limited access to the "back-up" credit facility were clearly influenced by the non-utility liquidity needs.

The more pertinent question, however, is the degree to which it should have forced DP&L into issuing $250 million in long-term debt at an especially chaotic time and against extraordinarily high spreads on debt issuances. Instead of structuring a dedicated credit and liquidity program that focused only on utility needs, PHI used a money pool upon which DP&L relied on for monthly amounts that ranged as high as $164 million before the credit crises brought that access to a sudden halt. On top of that, PHI was employing a pattern of permitting DP&L's short-term debt to run at high levels before replacing it with long-term debt.

A more utility-focused approach to financing should have produced greater flexibility through allowing DP&L greater access to the short-term credit facility, as needed to avoid the market chaos of late 2008. As it was, customers got neither the benefit of the interest costs saved by PHI's approach nor the interest-rate protection that long-term debt issued at more normal times would have provided.

Q. Do you agree then that DP&L could not have foreseen the potential for losing access to the commercial paper market?

A. Commercial paper access dries up occasionally, and has done so several times in the past. Certainly, predicting the timing of loss of access to the commercial paper market by DP&L is not possible, and anticipating that markets will remain closed indefinitely is not expected. Nevertheless, as we have been discussing, DP&L ended up not having the backup that its reliance on commercial paper required; *i.e.*, an equivalently-sized credit facility that acts as a source of "back-up liquidity." This back-up is not a matter of strategy, but of necessity if one is to work through commercial paper dealers for short-term debt. If the commercial paper markets fail, the issuers must have access to cash to pay their outstanding paper when due. Indeed, this is the primary function of the PHI $1.5 billion credit facility. The credit facility line must be available to DP&L when the commercial market dries up; that is its specific purpose, and why DP&L pays fees for it that are included in rates. DP&L should have had access to the credit facility up to its sub-limit of $500 million when the commercial paper market failed, which would have provided sufficient liquidity to avoid the long-term financial markets for another year, if necessary. However, PHI claims that the closing of the commercial paper markets forced DP&L to issue $250 million of first mortgage bonds in a severely distressed market, when it should have had up to $500 million of access to the PHI credit facility. As we have shown elsewhere, however, the reason for the timing of DP&L's $250 million bond issuance was due to PES' and CEH's liquidity needs for potential collateral calls, rather than the closing of commercial paper markets.

7. *Recommended Ring Fencing Measures*

Q. What do you consider to be the appropriate overall structure for establishing ring fencing measures?

A. The most effective means of achieving utility insulation through ring fencing is through a state statute that is enforced by a regulatory body, or, absent that, for the regulatory body to require affirmatively (as fully as it can under existing statutory powers) the creation and maintenance of and regular reporting on specific measures. Our belief is that any financial restrictions imposed solely through internal corporate policies are weak because they may be changed at any time. Restrictions that are part of bank credit agreements may also be changed through amendments and are subject to termination with the expiration of the credit facility.

Q. What has been done in the industry to provide for insulation?

A. We recommend that the Commission begin with adoption of the key measures that the Oregon PUC ordered in connection with the PGE/Enron merger, specifically including:

- Restriction of any distribution from utility to parent that would cause utility equity capital to fall below a specified level of total capitalization
- Maintenance of separate utility books and records and accounting systems
- Maintenance of separate debt and preferred stock ratings
- Maintenance of a utility-only cash management system
- Financing of utility operations separately from affiliates and the parent on both a short-term and long-term basis
- Separate utility management responsible for the day-to-day operations of the utility
- Issuance to an independent shareholder a single "golden share" of new junior preferred stock that restricts utility rights to commence a voluntary bankruptcy.

Q. Are there additional measures that you believe to be appropriate?

A. Yes. They include a number of protections in addition to those applied at PGE: limits on money pool arrangements, including separate pools for regulated and unregulated subsidiaries; separate credit facilities; no inter-company loans with affiliates; no pledging of utility assets or cash flow for other than utility purposes; and better separation of boards of directors; and clear penalties for violations.

Q. Do you have any general recommendations about disclosure?

A. Yes. We believe that PHI and DP&L must be significantly more willing to discuss their future plans and forecasts for non-utility businesses. We share the concern that those who rate utility debt have expressed about growth in the size of and changes in the nature of non-utility businesses. Rating agencies have access to the forecasts of all holding company entities, acting as "insiders" to protect the interests of debt holders. We believe that regulators have an important role in assuring that such changes do not become apparent only after they have served to alter risks significantly.

We feel so strongly about this that we believe failure to find a way to accommodate this need should call for an end to the housing of important utility operations within a holding company whose plans are not reasonably transparent to regulators, albeit with proper deference to the confidentiality that such information requires. However, we emphasize that access to company confidential information in no way replaces the need for ring fencing for DP&L. Protections are required that are continually in effect and that do not require regulators or any other body to forecast failures in order to be enforced.

Q. Did you seek to learn about the business and financing plans at PHI?

A. Yes. In data request PSC-AFF-3Staff asked DP&L to "provide current financial forecasts and financing plans for DP&L and PHI consolidated for as far into the future as they exist."

Q. What is the importance of Commission access to such information?

A. This information provides important context for judging actions taken to address utility needs. As we have stressed in this testimony, affiliation brings with it a natural inclination, and certainly an incentive, to combine less risky utility operations where doing so will ease access to or costs of acquiring capital for non-utility businesses. Understanding what a holding company's plans are can provide important context for judging matters of direct regulatory interest. The November 2008 debt issuance is a good example. Understanding what holding company plans were before the financial crisis and how the crisis affected those plans would have been useful in assessing the reasons for the financing.

At a broader level, continuation of a utility's membership in a holding company should be and remain contingent upon comfort that there remains a good fit between utility operations and the nature and magnitude of other businesses. The Constellation crisis underscores the need for assuring that fit. Regulators should not face either bankruptcy or the forced sale of their major utilities as a cost of a holding company's doing business in other arenas.

The question of that fit has been a matter of interest to rating agencies as well. It has recently become clear that the nature of non-utility businesses and even their size in relation to utility operations is an important factor to investors in determining risk levels. Those charged with protecting the public interest have, in our view, at least an equally compelling interest in assuring that entry into and growth of non-utility business does not add undue risk to utility operations. In addition to those issues and concerns of immediate consequence, it is important for commissions to understand where management sees its businesses going into the future.

Q. How did the Company respond to your request?

A. We received the information for DP&L, but the Company declined to provide information concerning non-utility or consolidated operations.

Q. What is the consequence of that refusal?

A. If there is no other way for key Commission personnel to remain generally aware of such plans and forecasts then it will, in our judgment, be deprived of information that: (a) may prove relevant to specific utility requests or proceedings, and (b) is important in providing comfort that the holding company is not planning future activities that would change the risks and other circumstances that regulated utilities may face.

Much of our testimony focuses on specific steps for mitigating the financial risks that affiliation with riskier business imposes on utility subsidiaries. However, even full adoption and faithful execution of all of these steps in a programmatic way cannot ensure that undue harm will not befall a utility because of those risks. Providing an opportunity for Commission personnel to stay reasonably current on where a holding company is headed helps give them an ability to consider looming risks and issues, much as management and the board do with the kind of information that Staff sought.

Q. How would you propose to deal with the sensitivity of such information?

A. There is no question that this information is among the most sensitive that a holding company develops, and that it should not be released to or available to the public. We would not propose public "proceedings" that address such information. Rather, periodic sharing of information informally would be sufficient to give Commission personnel both the context they need for handling matters that do require formal action, and for assessing whether any developments foreshadowed by the information merit more extensive review and assessment.

Periodic examinations of affiliate relationships and transactions, provided that they include a robust review of financial issues, provide another method for exchanging future-oriented information outside a "litigation" context and in a manner that promotes confidential treatment. Certainly, when we perform such affiliates engagements for regulators, such information is a standard request, either through interviews or data requests. We have been performing such engagements for approximately two decades and we routinely get the information that Staff sought in this request.

Q. Discuss the significance of holding-company leverage.

A. One important risk factor for utility subsidiaries is the use of significantly higher levels of leverage (*i.e.*, lower levels of equity) at the holding company than exist at the utility-subsidiary level. The effect of making non-utility business more highly leveraged increases their risk of failure, which can have consequences that cascade down to the utility subsidiaries.

Q. You sought information about holding company leverage; did you ultimately find any problems with leverage at PHI or DP&L?

A. No. PHI has acted responsibly to maintain utility equity. However, PHI's current performance does not obviate the need to assure continued equity maintenance through enforceable requirements on a going-forward basis.

Q. What has been PHI's approach to parent leveraging?

A. We asked about policies for the past four years. PHI responded that its policy has been to target holding company and utility equity levels in the mid- to high-40 percent range. We find this approach to be sufficiently conservative. Maintaining these goals and achieving them are important to continuing the holding company's effective performance in this area. We view monitoring of projected equity levels and ensuring that realistic plans exist to maintain them into the future as very important. Such monitoring is one of the goals that information like that requested in PSC- AFF-3 (but not supplied) seeks to further.

Q. You also examined risk management; did you find any significant gaps there?

A. No. From an organizational and structural perspective, we found PHI's approach, structure, and policies to be appropriate, again recognizing that assuring their continuation into the future, as well as their maturation as the industry learns important new lessons about risk, will be critical.

Q. Please describe the role of a structured risk management program at an enterprise like PHI.

A. Such a program is necessary to ensure that the enterprise continually evaluates operations to promote, create, and assure the existence of a number of attributes, including: (a) that all risks being undertaken are understood, (b) adoption of defined and appropriate tolerances for risks individually and in aggregate, (c) establishment of limits on the risks that may be borne, (d) undertaking of continual measurement versus limits of the risks it faces in all its business areas, (e) prompt and candid reporting of each case in which limits are exceeded intentionally or otherwise, (f) holding those whose business activities create risk accountable for violations or deviations,[1] (g) approval of products that create and mitigate risk, (h) examination of how changing business operations and the environment in which they operate affect risks and the enterprise's appetite for bearing them, and (i) periodic review and updating of the risk profiles and risk policies of each business area.

Such a program should be led by a senior holding company executive (typically termed the chief risk officer) with dedicated risk management responsibility and a sufficient level of independence from the operations creating risk for the enterprise, supported by oversight from a senior holding company executive group. That group, which most companies we have seen term a corporate risk management committee, needs to meet regularly and address programmatic risk issues, examine particular risks that current or pending circumstances make more critically important, verify compliance with risk policies and limits and address deviations, and provide for regular reporting to the board of directors. Effective risk management also requires a dedicated risk management function operating at a high level of authority and with reasonable independence of those who create risks within the business area. Business areas that create risk, such as those operating in energy markets, must also provide adequate separation of responsibilities (front, middle and back office are the terms generally used to describe this split) to assure that entry of transactions and definition of their details are both thorough and honest, in

[1] Violations generally concern themselves with actions by personnel and thus lend themselves to "fault" (*e.g.*, an employee enters a transaction that will cause a counterparty's specified and approved credit limit to be exceeded). Deviations generally do not arise from individual action, or imply fault, but nevertheless produce results that are out of compliance with norms or limits (*e.g.*, a movement of market price causes exposure under already existing agreements with a counterparty to rise above its credit limit), and therefore require identification and mitigation.

order to permit a proper assembly of the information needed to measure risks appropriately.

Given the nature of PHI's non-utility activities, the failure to manage and mitigate risk through adoption of an appropriate risk management program and structuring it to establish high-level oversight, separation of responsibilities, and clear accountability within each business area would unreasonably increase the risk that its utility subsidiaries would suffer financial harm.

Q. What did you observe about PHI's approach to risk management?

A. It took an extended period of time to secure the data required to form such observations. Thus, we did not have the benefit of substantial follow-up to verify execution details. We did, however, gain enough information to verify that PHI employs people in, structures responsibilities in, and operates a risk management program whose structure, governing documents, and general areas of routine inquiry conform to what we have seen at other utility holding companies that operate significant wholesale and retail energy businesses, along with large utility operations. The company has subjected its risk management structure and program content to outside review (particularly in the wake of the difficulties that followed the great financial crisis), which we view as important for remaining current with developments in a volatile and risky industry.

Q. Did you find any reason to suggest changes in risk management?

A. From an organizational and program content perspective we did not. Nor did we see, from reviewing the tangible indicators of what the chief risk officer and corporate risk management committee have addressed, any areas that concerned us. We believe that PHI's risk management approach structure and program management have progressed at a representative pace over recent years as the industry has changed, that the company is open to outside review of them, and that the result is a risk management organization and program that are appropriate for protecting utility interests. We emphasize in making this conclusion that maintenance of what exists and continuing to enhance it as industry knowledge grows and as industry circumstances change will be critical to maintaining this condition.

Q. Do you believe that measures such as these can eliminate the risk that utilities face from affiliation with riskier businesses?

A. No. Even with the best existing insulation, contagion and the linkage to a bankrupt parent will still occur, as perfect ring fences are impossible to construct. However, the PGE ring fencing was very successful in safeguarding the company's cash and assets. In contrast, as noted previously, two other Enron subsidiaries, Transwestern Pipeline and Northern Natural Gas, pledged assets as collateral for loans and passed the funds to Enron just before its collapse. Enron was unable to similarly borrow money from PGE, illustrating the effectiveness of its financial management insulation.

Q. Given the inability to eliminate these risks entirely, what should a utility regulatory commission do about these risks?

A. It is essential for a commission to establish mitigation measures, to examine periodically their existence and sufficiency, to remain sufficiently informed about holding company plans to identify whether particular business lines or sizes may change enough to shift risks materially, and to isolate any financial penalties that remain to a utility (comparing it to existence without non-utility affiliates) for purposes of keeping the costs of those penalties out of rates for utility service.

Q. **What then should we expect ring fencing to accomplish?**

A. The most important benefit of ring fencing is to protect the utility business's cash and assets from being "reassigned" within the holding company or claimed by creditors of the holding company or affiliates in bankruptcy proceedings. Ring fencing also may eliminate or minimize the cross-subsidization of the holding company and its unregulated businesses by the utility. This latter benefit assures that utility customers do not pay financing premiums even in cases where there is no affiliate distress. Another benefit of effective ring fencing is, as we have noted above to improve the utility's credit rating by making it closer to that of a "stand-alone" entity.

8. Ring Fencing Costs for Utility Customers and Non-Utility Businesses

Q. What is the cost of ring fencing to DP&L and its customers?

A. One cannot argue against ring fencing on the grounds that it will cost customers more. On a net basis, ring fencing should actually cause DP&L's costs to fall; at the least, they will not increase. However, we emphasize that the first priority of ring fencing is protecting the utility, and not lowering its costs. The point here is that regulators should not be loath to provide this protection out of concern that it will impose added costs on customers.

Several of our ring fencing recommendations fall into established areas of protection and are directives to maintain or solidify these protections at no cost. These recommendations include separate cash management and accounting systems, no inter-company loans, not pledging DP&L assets for affiliate benefit and restricting assets sales without Commission approval. In each of these categories, DP&L and PHI already have the appropriate system in place, or are already restricted by existing credit agreements and corporate procedures. We believe that these important protections, which do not require utilities to incur significant cost, should also be ordered by the Commission rather than relying on corporate policies or credit agreements that may be changed or expire.

The establishment of a minimum equity requirement should have no incremental cost if it is at an appropriate level. DP&L targets equity as a percentage of total capital of in the "high forties" percentage range. The minimum equity level should be set sufficiently lower to allow DP&L operating room without having to carry equity capital above its target or the allowed level included in rates; we recommend the minimum should be set no lower than at 40 percent of total capital.

The requirements that DP&L not participate in the current money pool and that PHI establish separate credit facilities for the utilities should provide both protection and be at a negative cost to DP&L. We believe that the most effective way to provide both protection and efficiency to DP&L is through the establishment of a money pool that includes only the utilities and possibly the parent as an investor only. Such a "utility" money pool would be able to exchange funds at low-cost rates without loaning to PHI's risky unregulated businesses. Replacing PHI's consolidated credit facility (when it expires) with a utility-only facility will retain economies of scale, and should produce pricing below that of a facility that also includes PHI and its non-utility businesses. We are confident that utility-only pricing will be lower than "consolidated pricing" when compared on a parallel, "apples to apples" basis.

Establishing the bankruptcy-remote protection entity or preferred stock discussed earlier will involve legal fees, but the template for these vehicles has already established by PGE and numerous other corporate examples. In any event, those are costs that should not be borne at the utility level; they are required only by reason of the inclusion of non-utility businesses. The reporting process to the Commission is only on an annual basis and should carry a low cost. Liberty believes that the small costs involved with a few of the ring fencing measures are far overridden by the benefits to of an incrementally higher credit rating (as conservatively estimated by Staff witness Rothschild) and access to a utility-only credit facility that will carry lower costs. The protections that DP&L will accrue from ring-fencing will therefore come at no cost or a "negative" cost.

Q. What is the cost of ring fencing to the non-utility businesses of holding companies like PHI?

A. We expect that PHI's non-utility businesses will experience higher capital costs if debt insulation is required. These entities currently enjoy the cross-subsidization of inexpensive money from DP&L and PEPCO through the money pool and from the consolidated PHI credit facility. The riskier non-utility businesses would not have access to either of these sources if they were required to raise their own capital without being included in a package that includes the much financially stronger utilities. If these entities are no longer allowed to be linked to the utilities in financial packages, their stand-alone cost of capital would have been at least 2-3 percent higher five or more years ago. We expect it could be significantly more than that now. DP&L did not provide the information we required to make a current, more accurate estimate. Specifically, we lack current information on "BB" or lower corporate short-term interest rates. If they are more willing now to provide solid information, we are of course open to re-evaluating the gap.

9. Summary of Recommended Measures

Q. Please summarize your recommended measures.

A. As we have stated earlier, the effective means of achieving utility insulation through ring fencing is to require the creation, maintenance, and regular reporting on measures specifically ordered by the Commission or statute. The rating agencies have expressed a preference for ring-fencing required by statute or regulatory order. Financial restrictions imposed solely through internal corporate policies are weak in that they may be changed at any time. Restrictions that are part of bank credit agreements may also be changed through amendments and are subject to termination with the expiration of the credit facility.

Q. Please list the specific, mandatory recommendations you propose for the protection of the customers of DP&L.

A. We recommend that the Commission secure the institution of the following provisions:

1. DP&L shall not make any distributions that would cause its equity capital to fall below 40 percent of permanent capital.
2. DP&L may not participate in any money pool that involves non-utility businesses, operations, or participation.
3. PHI must establish separate credit facilities for its utility subsidiaries, PHI and its unregulated subsidiaries through solicitation processes that are completely independent and wholly unconnected.
4. DP&L and PHI must establish a bankruptcy-remote special purpose entity or class of preferred stock that will protect DP&L in the event of a holding company bankruptcy.
5. Separate cash management systems must be maintained; those that involve DP&L must be separate and distinct from those of the holding company and any non-utility affiliate.
6. DP&L may not enter into any inter-company loans, guarantees or credit support agreements with the holding company or any affiliate, nor may any expectation of any form of utility support for non-utilities be created.

7. DP&L must maintain separate accounting books and records using systems separated from those of the holding company and all affiliates.
8. DP&L and PHI must provide Commission access to all books, records, documents, data, board minutes, presentations and forecasts of DP&L, PHI and all PHI subsidiaries and affiliates.
9. No DP&L assets, financial support, or cash flow may be pledged or used as collateral for the benefit of any entity except DP&L, and holding company and affiliate financing agreements and arrangements must disclaim any informal representation, commitment, or expectation of such support.
10. DP&L asset sales of greater than $20 million must be approved in advance by the Commission.
11. DP&L and PHI must establish an annual reporting process regarding the status of each of the ring fencing requirements.

Q. Does this conclude your testimony?

A. Yes.

Exhibit LCG-1: Liberty Witness Qualifications

Antonuk Resume

Areas of Specialization

Executive management; management audits and assessments; service quality and reliability management and measurement, utility planning and operations; litigation strategy; management of legal departments; human resources; risk management; regulatory relations; affiliate transactions and relations; subsidiary operations; and testimony development and witness preparation.

Relevant Experience

Electricity

Project Manager for Liberty's management and operations audit of the electricity, natural gas, and steam operations of Con Edison for the New York Public Service Commission.

Project Manager for Liberty's audit of the fuel and purchased-power procurement practices and costs of Arizona Public Service Company for the Arizona Corporation Commission. Liberty completed audits relating to fuel procurement and management and on rate and regulatory accounting for related costs at Arizona Public Service Company for the Arizona Corporation Commission. The fuel and purchased power audit included extensive reviews of all physical and financial transactions of both the utility and a wholesale marketing affiliate, including the relationship between the two entities.

Project Manager for Liberty's examination of governance at a generation and transmission cooperative serving 16 distribution cooperatives across the state of Kentucky. This study comes in the wake of significant financial difficulties and will also address planning, budgeting, financial, and risk functions and activities.

Project Manager for Liberty's independent evaluation of LIPA's recovery of costs through its Fuel and Purchased Power Cost Adjustment (FPPCA) clause. This evaluation included an examination of: the reasonableness of costs recovered, the accuracy of costs recovered, Board authorization of the clause, and comparison to clauses in other jurisdictions.

Project Manager for Liberty's audit of Duke Energy Carolinas for the North Carolina Utilities Commission. Scope included compliance with regulatory conditions and code of conduct imposed by the Commission after the merger with Cinergy, and affiliate transactions and cost allocation methods.

Project Manager for Liberty's audit of affiliate transactions of Nova Scotia Power on behalf of the Nova Scotia Utility and Review Board.

Project Manager for Liberty's audit for the New Jersey Board of Public Utilities of the competitive service offerings of the state's four major electric companies. Scope included corporate structure, governance, and separation, service company operations and charges, inter-affiliate cost allocations, arm's-length dealing with respect to a variety of code-of-conduct requirements, and protection of customer and competitor proprietary information.

Project Manager and witness for the staff of the Arizona Corporation Commission addressing the merits of the proposed acquisition of UniSource by a group of private investors.

Project Manager and witness before the Oregon Public Utility Commission addressing the merits of the proposed acquisition of Portland General Electric by a group of private investors.

Engagement Director for Liberty's provision of engineering and technical assistance to the Vermont Public Service Board in connection with review of public necessity and convenience related to the Northwest Reliability Project, which would add a major new 345kV transmission plan to provide an additional source of electricity to serve Vermont's major load growth in its northwest region. The project involved transmission reinforcements at lower voltages and significant substation upgrade work. The proceedings had numerous public, private, and government interveners, who raised issues regarding project need, available electrical alternatives, routing and design, and electromagnetic radiation.

Project Manager for Liberty's support for the New Hampshire Public Utilities Commission in its charge to oversee the divestiture of the Seabrook nuclear plant as part of a major restructuring settlement. The sale produced record high compensation for nuclear facilities in the country.

Project Manager and witness for Liberty's assessment of fuel procurement, affiliate transactions, and automatic adjustment clause implementation for the staff of the Nova Scotia Utility and Review Board in rate case of Nova Scotia Power.

Project Manager for Liberty's engagement on behalf of Boston Edison to examine the company's affiliate relations, including issues of the valuation of assets transferred to an affiliate. Testified in proceedings before the Massachusetts Department of Telecommunications and Energy (formerly the Department of Public Utilities) on several telecommunications issues, including: (a) development of competition, and legislative and regulatory policy changes supporting it, (b) electric utility entry into telecommunications markets, (c) costs, prices, and market value of network elements, (d) requirements of the Telecommunications Act of 1996, (e) assessment of compliance with commission orders, company procedures, and service agreements regarding limits on affiliate interactions, (f) inter-company loans, guarantees, and credit support among utilities and their affiliates, (g) accounting for affiliate transactions, (h) obligations to allow nondiscriminatory access to network infrastructure to third parties, and (i) cost pools, overhead factors, and allocation of common costs among utility and non-utility affiliate activities and entities.

Project Manager for Liberty's major consulting engagement for the New Hampshire Public Utilities Commission. Liberty examined management, operations, and costs at Public Service Company of New Hampshire/Northeast Utilities, which is engaged in the operational and cost-accounting separation of its network into segments, for the purposes of restructuring service offerings to allow competition in certain aspects of electric-energy supply. This engagement included an assessment of valuations of nuclear and fossil units, as well as supply contracts with independent-power producers. Liberty also assisted in efforts to settle rate case and restructuring disputes involving, among other issues, stranded costs associated with power plants. The scope of Liberty's work included the development of plans and protocols for power plant (fossil, hydro, and nuclear) and power supply contract assets, as well as the oversight of activities associated with asset auctions.

Engagement Director for Liberty's evaluation of corporate relations and affiliate arrangements of Dominion Resources, Inc. and Virginia Power for the Virginia State Corporation Commission. This project addressed all significant aspects of corporate governance, operating relationships, and affiliate arrangements between the two entities.

Project Director for Liberty's evaluation of a report prepared by a consultant to the Hawaii Public Utilities Commission on the relationship between Hawaiian Electric Industries (HEI), a diversified utility-holding company, and Hawaiian Electric Company (HECO), its principal subsidiary and operating electric utility.

Project Director for all aspects of Liberty's comprehensive management and operations audit of West Penn Power Company for the Pennsylvania Public Utility Commission. Managed focused reviews of the Company's affiliated costs, power dispatch and bulk power transactions, customer services, finance, and corporate services. Presented testimony before the PAPUC on behalf of the Office of Trial Staff regarding the results of the audit in West Penn's rate case.

Lead Consultant for affiliate relations for Liberty's assignment of providing assistance to Delmarva Power & Light Company in developing and implementing self-assessment and continuous-improvement processes.

Project Director for Liberty's reviews of fossil-fuel procurement and administration in Liberty's management/performance audits of the Centerior Energy Company's operating companies- Cleveland Electric Illuminating Company and Toledo Edison Company- and Ohio Edison, Monongahela Power (an Allegheny Power System operating company), and Cincinnati Gas & Electric, for the Public Utilities Commission of Ohio.

Served as advisor to the administrative law judge of the Delaware PSC responsible for hearing cases regarding the implementation of the new law that restructures the electric-utility industry in Delaware.

Engagement Director for nuclear-plant performance-improvement projects that Liberty conducted for Duquesne Light Company, Centerior Energy, Nebraska Public Power District, and Pennsylvania Power & Light Company (PP&L).

Engagement Director for a Liberty assignment for Florida Power Corporation, regarding a proposal by the Tampa Electric Company to construct transmission lines to serve the cities of

Wauchula and Fort Meade, Florida. Liberty's testimony helped convince the Florida Public Service Commission that Tampa Electric Company's proposed line was uneconomic.

Directed Liberty's engagement to assist a regional electric generation and transmission cooperative, whose members' combined operations make it a major competitor in the state's electricity business, to conduct its first-ever comprehensive and formal strategic-planning process.

Natural Gas

Project Manager for Liberty's project for the District of Columbia PSC to examine the usage and cost recovery of a hexane injection strategy used by Washington Gas Light.

Project Manager for Liberty's examination of safety programs and activities of NiSource's Maine subsidiary Northern Utilities for the Maine Public Service Commission.

Project Manager for Liberty's focused and general management audits of NJR, New Jersey Natural Gas, and affiliates for the New Jersey Board of Public Utilities. This project included detailed examinations of affiliate relationships, governance, financing and utility ring-fencing, compliance with New Jersey EDECA requirements for affiliate separation, protection of confidential information, non-discrimination against third-party competitors with utility affiliates, and other code-of-conduct issues. Personally performed the reviews of governance, EDECA requirements compliance, and legal services.

Project Manager on a major focused audit of Peoples Gas/Integrys that Liberty performed for the Illinois Commerce Commission. Audit topics included natural gas forecasting, portfolio design and implementation, gas purchase and sale transactions, controls, organization and staffing, asset management, off-system sales, storage optimization, and all other issues related to gas supply over a period of eight years.

Project Manager and witness on three recent audits of fuel (primarily coal and natural gas) procurement and management practices of Nova Scotia Power, a review of the merits and mechanics of a company-proposed automatic recovery method for energy costs, and an audit of affiliate relationships (including coal, electric power, and natural gas procurement activities) performed for the Nova Scotia Utility and Review Board.

Project Manager for Liberty's focused and general management audits of SJI, South Jersey Gas, and affiliates for the New Jersey Board of Public Utilities. This project included detailed examinations of affiliate relationships, governance, financing and utility ring-fencing, compliance with New Jersey EDECA requirements for affiliate separation, protection of confidential information, non-discrimination against third-party competitors with utility affiliates, and other code-of-conduct issues. Personally performed the reviews of governance, EDECA requirements compliance, and legal services.

Project Manager for Liberty's work with staff of the Virginia State Corporation Commission to evaluate the services of an affiliate providing gas portfolio management services under an asset management agreement with Virginia Natural Gas, an operating utility subsidiary of Atlanta-based AGLR.

Project Manager for Liberty's focused audit of NUI Corporation and NUI Utilities. This audit included a detailed examination of the reasons for poor financial performance of non-utility operations, downgrades of utility credit beneath investment grade, and retail and wholesale gas supply and trading operations. Also examined performance of telecommunications, engineering services, customer-information-system, environmental, and international affiliates. The audit included detailed examinations of financial results, sources and uses of funds, accounting systems and controls, credit intertwining, cash commingling, and affiliate transactions, among others. Liberty's examination included very detailed, transaction-level analyses of commodities trading undertaken by a utility affiliate both for its own account and for that of utility operations. Project Manager for Liberty's comprehensive management audit of United Cities Gas Company for the Tennessee Public Service Commission. Responsible for the focused reviews of affiliate interests, executive management and corporate planning, and vehicle management.

Lead Consultant in Liberty's management audit of Connecticut Natural Gas Company for the Connecticut Department of Public Utility Control (DPUC). Responsible for reviews of organization and executive management and legal management.

Lead Consultant in Liberty's management audit of Southern Connecticut Gas Company for the DPUC. Responsible for organization and executive management, affiliates, and legal management. Included valuation of a major, rate-based LNG facility being offered for sale.

Directed Liberty's management audit of Yankee Gas Services Company for the DPUC.

Engagement Director for Liberty's evaluation of regulatory needs and alternatives for the Georgia Public Service Commission in regulating the state's local-gas-distribution companies in the aftermath of FERC Order 636.

Project Director for Liberty's review of gas-purchasing policies and practices at Pike Natural Gas Company and Eastern Natural Gas Company for the Public Utilities Commission of Ohio. Responsible for the review of organization and staffing and regulatory-management issues.

Combination Utilities

Engagement Director for Liberty's examination of the cost-allocation methods of Baltimore Gas & Electric Company and its affiliates for the Maryland Office of People's Counsel.

Project Director for Liberty's focused management audit of affiliate transactions of Public Service Electric & Gas Company (PSE&G) and the unregulated subsidiaries of Public Service Enterprise Group, Inc., the parent, for the New Jersey Board of Regulatory Commissioners. Task leader for the review of organization and planning, and executive management.

Project Director for Liberty's management and operations audit of New York State Electric & Gas Corporation for the New York Public Service Commission (NYPSC). Responsible for managing the review of corporate planning and organization, service centralization, specific corporate services, and finance and accounting.

Project Director for Liberty's management and operations audit of Central Hudson Gas & Electric Corporation for the NYPSC.

Telecommunications

Arbitrator named by the District of Columbia Public Service Commission to address industry-wide need for amendments to interconnection agreements as a result of the FCC's Triennial Review Order.

Project Manager for assistance being provided to the Administrative Law Judge of the Delaware Public Service Commission hearing the arbitration to address industry-wide need for amendments to interconnection agreements as a result of the FCC's Triennial Review Order.

Project Manager for Liberty's engagement to serve as advisors to commissioners of the District of Columbia Public Service Commission in their review of the Section 271 application of Verizon to provide in-region, interLATA service in the District.

Project Manager for Liberty's engagement to serve as advisor to the administrative law judge of the Delaware Public Service Commission in the review of the Section 271 application of Verizon to provide in-region, interLATA service in the state.

Retained by the Idaho PUC to serve as administrative law judge in complaint proceedings involving three paging companies and Qwest, involving a variety of financial disputes arising out of interconnection and tariff purchases.

Conducted wholesale performance metrics training for staff members and commissioners of the Pennsylvania Public Utility Commission as part of efforts to monitor service quality and payments under the Verizon Performance Assurance Plan adopted in connection with the RBOC's entry into the in-region inter-LATA market in Pennsylvania.

Engagement Director for Liberty's comprehensive financial review of Verizon New Jersey Inc. (VNJ) for the New Jersey Board of Public Utilities. The review had three parts: a financial evaluation; a review of merger costs and savings; and an assessment of affiliate costs and transactions.

Engagement Director for Liberty's audit of Ameritech-Ohio policies, procedures and compliance with service quality performance requirements under Ohio's Minimum Telephone Service Standards.

Engagement Director for Liberty's audit of Qwest's performance measures for the Regional Oversight Committee (ROC). Responsible for the evaluation of the processes and data tracking of several hundred wholesale and retail performance indicators including service areas such as provisioning, OSS access, maintenance and repair, and billing.

Project Manager and hearing administrator for Qwest's 271 hearings for the commissions of Idaho, Iowa, Montana, New Mexico, North Dakota, Utah, and Wyoming.

Engagement Director for Liberty's assistance provided to the Staffs of the Virginia State Corporation Commission and the New Jersey Board of Public Utilities in the implementation of the 1996 Telecommunications Act.

Project Manager for Liberty's assistance to Delaware PSC arbitrators in seven different interconnection cases arising out of the Telecommunications Act.

Served on an arbitration board in Mississippi, and as the sole arbitrator in two cases in Idaho regarding interconnection agreements between incumbent local-exchange companies and new entrants to the local telephone market.

Engagement Director for Liberty's work determining permanent prices for the unbundled-network elements of Southwestern Bell Telephone for the Oklahoma Corporation Commission.

Engagement Director for Liberty's provision of arbitration services to the North Dakota Public Service Commission and Nebraska Public Service Commission in cases involving implementation of the Telecommunications Act of 1996.

Engagement Director for Liberty's combined comprehensive management/affiliate-relations audit of Bell Atlantic - Pennsylvania for the PAPUC, and affiliate relations audit of Bell Atlantic - District of Columbia for the Public Service Commission (DCPSC) of the District of Columbia. Served as team leader with responsibility for the coordination of the review of executive management, finance, and support services.

Engagement Director for Liberty's examination of the accounting and allocation on lobbying costs of Bell Atlantic for an 8-year period for the DCPSC. Engagement included an examination of the propriety of policies and procedures for assigning and allocating lobbying costs.

Engagement Director for a management audit of GTE South, Inc. for the Kentucky Public Service Commission. This examination included a review of GTE's affiliate transactions.

Project Director for Liberty's evaluation of New York Telephone's transactions with affiliates for the NYPSC. Responsible for the review of affiliates involved in directories publishing, government affairs, international activities, information services, and the legal-affairs entity.

Project Director for Liberty's management audit of the affiliated interests of C&P Telephone of Maryland performed on behalf of the Maryland Public Service Commission.

Engagement Director for Liberty's two assignments for the DCPSC in reviewing Bell Atlantic - District of Columbia's construction-program planning and quality-of-service standards.

Other Companies

Set up and managed service and facilities section of the PP&L Regulatory Affairs Department. Counseled utility management on regulatory and legislative matters. Litigated rate related and facility construction proceedings before agencies and the courts.

Attorney for the PAPUC. Assigned as counsel to the Commission's Audit Bureau in developing a comprehensive management-audit system. Negotiated contracts for the first commission-ordered management audits in Pennsylvania. Revised Commission organization and practice to conform to regulatory-reform legislation.

Vickroy Resume

Areas of Specialization

Mr. Vickroy has over 25 years of experience in the utility industry, including fifteen years as a management consultant. He has managed and performed numerous high-level consulting assignments at companies and utility commissions in over 25 states. His areas of expertise include corporate finance and treasury management; capital markets and financing vehicles; utility industry restructuring; utility rates and pricing; non-regulated lines of business and affiliations; strategy and planning issues; asset valuations and decision-making; capital and expense budgeting and forecasting; corporate resource allocation; holding company affiliate issues; and financial and economic analysis.

Relevant Experience

Lead Consultant on electrical energy and capacity purchases and sales and hedging and capital budgeting on Liberty's management and operations audit of the electricity, natural gas, and steam operations of Con Edison for the New York Public Service Commission.

Served as Lead Consultant in an audit of the fuel and purchased-power procurement practices and costs of Arizona Public Service Company for the Arizona Corporation Commission. Responsible for reviews of its contracting and supply-management practices for natural gas. His assignment in the Arizona project included an examination of the reasons for differences in off-system sales between Arizona Public Service, including specifically PNM and Salt River Project

Lead consultant for a management audit of strategic, financial, and power supply and market issues at East Kentucky Power Company for the Kentucky Public Utilities Commission.

Lead consultant for non-regulated affiliates and holding company cost allocation at Delmarva Power and Light for the Delaware Public Service Commission.

Reviewed finance and the protection and insulation of the utility from parent and non-utility operations and finances in Liberty's focused and general management audits of NJR/New Jersey Natural Gas the New Jersey Board of Public Utilities. Included detailed examinations of affiliate relationships, governance, financing, utility ring-fencing, compliance with New Jersey EDECA requirements for affiliate separation, protection of confidential information, non-discrimination against third-party competitors with utility affiliates, and other code-of-conduct issues.

Lead Consultant in three Liberty's audits of Duke Energy for the North Carolina, Indiana and Kentucky utilities commissions, focusing on issues of compliance with regulatory conditions and code of conduct.

Led the review of finance and the protection and insulation of the utility from parent and non-utility operations and finances on Liberty's focused and general management audits of SJI, South Jersey Gas, and affiliates for the New Jersey Board of Public Utilities. This project included detailed examinations of affiliate relationships, governance, financing and utility ring-fencing, compliance with New Jersey EDECA requirements for affiliate separation, protection of confidential information, non-discrimination against third-party competitors with utility affiliates, and other code-of-conduct issues.

Lead Consultant for examination of financing and risk management on Liberty's focused audit of NUI Corporation and NUI Utilities. This audit included a detailed examination of the reasons for poor financial performance of non-utility operations, affect of affiliate operations, including commodity trading on utility credit and finance, downgrades of utility credit beneath investment grade, and retail and wholesale gas supply and trading operations. The audit included detailed examinations of financial results, sources and uses of funds, accounting systems and controls, credit intertwining, cash commingling, and affiliate transactions, among others. Liberty's examination included very detailed, transaction-level analyses of commodities trading undertaken by a utility affiliate both for its own account and for that of utility operations.

Served as Lead Consultant in Liberty's review of acquisitions of UniSource (Arizona) and Portland General Electric (Oregon) focusing on utility financial insulation, governance, service reliability, access to information, and community presence issues.

Lead Consultant in Liberty's comprehensive analysis of the ratemaking implications of Commonwealth Edison's Chicago electric service outages for the Illinois Commerce Commission. Responsible for investigating and analyzing ComEd's capital budgeting, resource allocation, project management, expenditure levels and rate base impacts for operations leading up to and in response to the outages.

Lead Consultant in Liberty's review of the financial integrity and earnings of Verizon New Jersey's rate regulated and competitive businesses for the New Jersey BPU. Responsible for the financial evaluation of VNJ's earnings, capital structure, rates of return, dividend policies, credit ratings, financial reporting, SEC reporting, and BPU surveillance reports.

Lead Consultant in Liberty's financial audit for ratemaking purposes of Verizon New Hampshire for the New Hampshire Public Utilities Commission. Responsible for a broad and comprehensive analysis of the financial status of VNH, including an audit of the books and records of the Verizon parent, in order to assist the commission in determining rate base, rates of return and appropriate adjustments for the test year.

Project Manager for the development and implementation of regulatory financial systems and models for deregulated ratemaking at Pacific Gas and Electric Company. The project involved developing regulatory strategy, California PSC earnings monitoring models, data bases, analytical models and reporting for all regulatory requirements of PG&E's regulated businesses.

Led the development of a framework and strategy to resolve all electric industry restructuring issues between the State of New Hampshire, Public Service Company of New Hampshire, and the NHPSC. Project included assessment and valuation of all key assets and development of a disposition strategy for all generation assets, contracts and obligations. The project also included the assessment of alternative rate paths; planning for the securitization and recovery of stranded costs; and the development of provisions for power supply purchases during a transition period.

Team leader for the two separate reviews of the New York Power Authority's profitability, financial reporting, rate competitiveness, pricing policies, power plant economics and economic development programs in this management audit for the state of New York. NYPA is the largest generator and carrier of power in New York, providing over 25 percent of the electricity sold.

Team leader in providing consulting assistance to Kentucky Utilities in preparing its 1993 application for implementing an environmental surcharge. Responsibilities included analyzing legislation, analysis of capital expenditures, analysis of KU's Clean Air Act compliance plan, analysis of costs recoverable under the surcharge, and developing testimony, exhibits, special accounting systems, and rate tariffs.

Project Leader for providing consulting assistance to Big Rivers Electric in preparing its 1994 application for implementing an environmental surcharge. Responsibilities included a review and evaluation of the economics of a major investment in a flue gas scrubber, analysis of Big Rivers' Clean Air Act compliance plan, evaluating cost recoverable under the surcharge, and developing surcharge testimony, exhibits, accounting systems and rate tariffs.

Consultant in Liberty's management audit of GTE South - Kentucky for the Kentucky Public Service Commission. Responsible for the analysis of the financial-management of GTE as it relates to the operation of its GTE South subsidiary.

Lead Consultant in Liberty's management audit of Bell Atlantic - PA and DC for their respective commissions. Responsible for reviewing capital structure, finance and controller functions, financial systems, and treasury operations. Focus areas included the impact of telephone industry competition on capital budgeting, financial management strategy, and treasury operations.

Leader for all financial areas in the review of affiliate transactions among Public Service Electric and Gas, its holding company parent, and the extensive diversified businesses of the holding company. Responsible for evaluating PSE&G's consolidated finance functions to determine whether the financial integrity, flexibility, and cost of capital of the regulated utility had been adversely affected by the activities of diversified affiliates. Work included the review and analysis of the long-term financing, cash management, direct and indirect credit support mechanisms, investor relations, and all transactions between and among the affiliates.

Led the review of finance, cash management, budgeting, and rates in Liberty's comprehensive management audit of Southern Connecticut Gas for the Connecticut DPUC. Responsibilities included operational audits of all finance, regulatory and budgeting processes of SCG.

Led the review of the finance, cash management, budgeting, accounting and rate functions in Liberty's comprehensive management audit of Connecticut Natural Gas for the Connecticut DPUC. Work also included a focus on the financial impacts of CNG's non-regulated businesses, which includes a large steam system in downtown Hartford.

Led the review of the finance, cash management, budgeting, rates, and tax functions in Liberty's comprehensive management audit of Yankee Gas for the Connecticut DPUC. Evaluation included an in-depth analysis of the effectiveness of Yankee's capital and expense budgeting processes and the integration of market and competitive components into these processes.

Led the review of the finance, regulatory and accounting functions in Liberty's management audit of United Cities Gas for the Tennessee Public Service Commission. Responsibilities included a review of all financial functional areas, as well as a review of the impact of all affiliate transactions between the regulated and non-regulated businesses.

Led the evaluation of the financial relationships between Hawaiian Electric Industries and Hawaiian Electric Company for the Hawaii Department of Commerce and Consumer Affairs. The focus of the review was the credit and financial support provided by the utility company to the holding company and its diversified businesses.

Led the review and analysis of corporate governance, financial relationships and affiliate transactions between Virginia Power and its parent, Dominion Resources for the Virginia State Corporation Commission. The review included an evaluation of all utility and non-utility financing, governance and economic impacts. The engagement was in response to a well-publicized dispute between the holding company and Virginia Power.

Led the consulting and monitoring of contracting for electric supply by Western Massachusetts Power following the sale of its generation assets under electric deregulation.

Led the review and evaluation of the financial management practices of a major utility holding company. Engagement included an assessment of overall financial management and crisis-liquidity plans; strategic and business planning; asset valuations and their accounting impacts upon deregulation; independent power contract buy-downs; and rate reduction strategies.

Led the evaluation and recommendation of strategic lines of business for a major municipal utility facing industry deregulation.

Led the development of a strategic framework for the establishment and growth of non-regulated businesses for a major international electric holding company.

Development, analysis, recommendation of alternative generation and power resource strategies for regional generation and transmission company in preparation for electric deregulation.

Led review of all utility and non-utility financing, financial relationships, and affiliate transactions between a major utility holding company and its electric company subsidiary.

Lead on financial areas in evaluation of the diversified businesses of a major utility holding company. Determined the impact on financial integrity, financial flexibility, credit mechanisms, and the cost of capital of the substantially diversified businesses of the holding company.

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Criteria | Structured Finance | Legal:

Ring-Fencing a Subsidiary

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Ring-Fencing a Subsidiary

The evolution of structured finance techniques, and their adaptation by corporate credit structures, has expanded the methods by which the credit quality of a subsidiary might be rated higher than the credit quality of the consolidated entity. These methods, colloquially referred to as "ring-fencing," are described here.

Standard & Poor's takes the general position that the rating of an otherwise financially healthy, wholly owned subsidiary is constrained by the rating of its weaker parent. The basis for this position is that a weak parent has both the ability and the incentive to siphon assets out of its financially healthy subsidiary and to burden it with liabilities during times of financial stress. The weak parent might also have an economic incentive to filing the subsidiary into bankruptcy--if the parent itself were forced into bankruptcy--regardless of the subsidiary's "stand-alone" strength. Experience suggests that insolvent corporations will often jointly file with their subsidiaries--even those subsidiaries not themselves experiencing financial difficulty.

Before arriving at the rating of any particular subsidiary, Standard & Poor's assesses the credit quality of the consolidated entity of which the subsidiary is a part. No rating, per se, is assigned to the consolidated entity; rather, the credit-quality assessment is a pro forma measure of the consolidated entity's general ability to meet its obligations. (See "Consolidated Ratings Methodology" sidebar.)

Issuers and their advisors typically offer two particular devices to justify a ratings separation between the parent/group and the subsidiary: the protective covenant and the nonconsolidation opinion. The problem with these devices is that by themselves they do not go far enough in effectively insulating or "ring-fencing" the subsidiary from its parent.

The protective covenant is designed to restrict the shifting of assets and liabilities between parent and subsidiary. The covenant accomplishes this either by outright prohibition of asset transfers and dividend declarations or by subjecting such transfers and declarations to stringent tests. The parent may also offer a so-called "nonpetition" covenant, by which it undertakes not to file the subsidiary into bankruptcy.

Covenants are generally given little weight in the analysis of whether a subsidiary might be rated higher than its parent. Courts will rarely compel an entity to comply with or perform the terms of a covenant. They prefer instead to limit remedies to provable monetary damages in the event of breach of covenant and consequential loss. If a company breaches its financial covenants and thereafter goes into bankruptcy, any proven resulting damages would have to be recovered from the company's bankruptcy estate, most likely at a relatively low priority. It is, moreover, difficult to draft covenants that will cover every conceivable eventuality. Standard & Poor's assumes that management will, in keeping with its responsibilities to shareholders, attempt to devise ways to defeat covenants that are burdensome.

"Nonpetition" covenants are also problematic in that they are unenforceable as a matter of public policy. Although it views nonpetition covenants as an indication (at least, at the time given) of the parent's disinclination to filing a subsidiary into bankruptcy, Standard & Poor's measures the likelihood of the performance of any covenant (such as the obligation to pay timely debt service) by the level of the covenantor's own rating level. Standard & Poor's views compliance with nonpetition covenants as being, ultimately, more a question of willingness than of ability.

The second device is the offer of a "nonconsolidation" opinion by the parent. Nonconsolidation opinions are common in structured finance. The doctrine of substantive consolidation allows creditors of a bankrupt company to ignore the principles of the "corporate separateness" of parent and subsidiary if:

- The creditors can persuade the court that the parent was using the subsidiary to shelter the parent's assets; or
- The affairs of the parent and the subsidiary were so intertwined as to make the two entities essentially indistinguishable.

In appropriate circumstances, the court will "consolidate" the assets of the subsidiary with those of the bankrupt parent, thus allowing the parent's creditors access to the assets of the subsidiary. A nonconsolidation opinion addresses the degree of likelihood that a court will grant substantive consolidation based on the observance by parent and subsidiary of certain "separateness factors." Aside from the fact that they are fact-specific, limited in scope, and highly qualified, nonconsolidation opinions specifically do not address the likelihood of simultaneous bankruptcies of the parent and the subsidiary at the instigation of the parent. Even when a covenant package accompanies a nonconsolidation opinion, therefore, the potential still exists for a parent to act to the detriment of its subsidiary's creditors. Exceptions to the weak-parent/strong-subsidiary linkage have been made based on particular factual circumstances, such as transactions involving independent finance subsidiaries and regulated entities. Even in such instances, however, there typically remains some linkage. This linkage usually constrains the rating of an otherwise advantaged subsidiary to one full rating category (three "notches") above the credit quality of the consolidated entity. In cases where a regulated utility is the subsidiary, the three-notch, regulatory-based differential will not often be achieved, since it is only considered when the subsidiary is located in an actively regulated jurisdiction like Oregon, California, or Virginia. Similar examples of ratings that take serious regulatory oversight into account can be found in Australia and the United Kingdom.

The evolution of structured finance techniques, and their adaptation by corporate credit structures, has expanded the methods by which the credit quality of a subsidiary might be rated higher than the credit quality of the consolidated entity. Of course, corporate affiliation can never be totally ignored, even where the parent has adopted a number of these structuring techniques. When business dependencies exist between subsidiary and parent, such techniques may not be respected by the courts. These methods, colloquially referred to as "ring-fencing," are cropping up in a variety of financing situations, including:

- Acquisition financing (the incurring of debt by a newly formed entity for the purpose of acquiring an existing entity);
- Monetizing a subsidiary's dividend distributions (the formation by a low-rated parent of an intermediary subsidiary, interposed between the parent and its operating subsidiaries, for the purpose of borrowing funds, the debt service on such loans being derived from dividend streams received from the operating subsidiaries); and
- Corporate spinoffs (the formation by a single, low-rated parent of a new subsidiary, which then incurs debt for the purpose of acquiring a relatively profitable line of business, or assets, from the parent).

Exceptions to the Rule

Depending on the "stand-alone" strength of the subsidiary, a package of enhancements (including structural features, covenants, and a pledge of collateral) may be effective to raise the rating of the subsidiary a full rating category over the credit quality of the consolidated entity. (See "A Ratings Enhancement Package" sidebar.) If the subsidiary has multiple owners, one or more of which is capable of defending the subsidiary from the acts of a financially stressed or insolvent parent, an even wider rating differential may be merited. The basis for the rating differential is that the package may be viewed as reducing the means--as well as the incentive--of the parent to shift assets from and liabilities to the subsidiary, or to file it into bankruptcy. (The operational nature of the subsidiary's business distinguishes this approach from true securitizations in which differentials of three or more ratings categories can be achieved. Securitizations of statistically predictable pools of accounts receivable are, in the view of Standard & Poor's, fundamentally different from the business and financial issues characteristic of operating entities.)

Structure.

As noted above, parent/subsidiary linkage is prompted, in part, by two concerns:

- That a healthy subsidiary's assets may be consolidated with those of its insolvent parent; and
- That the parent will have the ability to cause the subsidiary to file itself into bankruptcy, despite the fact that the subsidiary is not itself experiencing financial difficulty. Ensuring that the subsidiary is a limited-purpose operating entity, somewhat similar to the "special purpose entity" (SPE) found in a securitization, may mitigate this bankruptcy risk.

While the SPE is, strictly speaking, a creature of securitization, its operating asset analogues are found in the limited-purpose operating entities employed in industrial-based or project-financed transactions. In the context of a "ring-fenced" transaction, Standard & Poor's expects that such limited-purpose entity will:

- Be "single-purpose";
- Incur no additional debt (beyond that sized into the rating and necessary for routine business purposes, such as trade debt and ordinary working-capital facilities to prestated levels);
- Not merge or consolidate with a lower-rated entity;
- Not dissolve; and
- Have an "independent director."

In the context of a "ring-fenced" transaction, the operative feature is the independent director.

Absent any stipulation to the contrary, a company's directors have a fiduciary duty to its shareholders. The fiduciary duties of the subsidiary's directors are understood to include the execution of the parent's instructions, including an order to file the subsidiary into bankruptcy voluntarily. (A financially healthy subsidiary should not properly be involuntarily filed by the parent, since the subsidiary would be able to pay its debts as they become due.)

To ensure that this duty is fulfilled properly, the charter documents of the SPE require the affirmative vote of the independent director, an individual with no tie or relationship to the parent, as a prerequisite to the SPE's voluntarily filing itself into bankruptcy. The charter documents of the SPE require the independent director to take into account the interests of the creditors of the subsidiary (including the holders of the rated debt), in addition to the interests of the shareholding parent, when deciding to file. The creditors of the subsidiary would almost certainly be prejudiced by such a filing.

As is the case in true securitizations, the SPE is most effective when paired with a nonconsolidation opinion. The combination of the SPE structure and the nonconsolidation opinion may provide some comfort that the parent and its potentially more highly rated subsidiary are adequately distanced from each other, thus justifying the existence of a rating differential between the credit quality of the subsidiary and the credit quality of the consolidated entity. Nevertheless, structural separation alone may simply elevate form over substance when the subsidiary has significant operating and business dependencies on the parent (and vice versa). Consequently, the advantages of structural separation may be lost if such dependencies exist.

An additional structural protection is the use by the subsidiary of a "lockbox" mechanism, whereby accounts receivable owed to the subsidiary are deposited by its customers directly into a bank account controlled by, and in the name of, the security trustee or collateral agent for the rated debt. The trustee or agent then allocates the cash according to a distribution mechanism designed to:

- Pay the costs of the subsidiary's operations;
- Settle administrative expenses; and
- Pay debt service while segregating cash from the direction and control of, and potential interference by, the lower-rated parent.

Covenants.

Together with structural (or regulatory) and collateral provisions, a tightly drafted covenant package is important in preserving the financial well-being and autonomy of the subsidiary. These covenants may include (but are not limited to):

- Dividend tests;
- Negative pledges;
- Nonpetition covenants;
- Prohibitions against creating new entities; and
- Restrictions on asset transfer and intercompany advances.

In structures where the subsidiary has affiliates, covenants prohibiting any intercorporate dealings whatsoever (even when subject to "arm's-length" tests) may be desirable because of the potential for abuse.

Collateral.

If the debt is fully secured by a pledge of all or substantially all of the assets of the subsidiary, the parent, in principle, has less freedom to deal with the assets of the subsidiary and, therefore, a reduced incentive to file the subsidiary into bankruptcy. The security usually takes the form of a subsidiary's general pledge of its assets to the collateral agent or security trustee, and a parent's pledge of its ownership interest, e.g., membership (LLC), partnership, (LP) or share (corporation interest) in the subsidiary as security for payment.

In support of the pledge, Standard & Poor's will request that the parent and the subsidiary provide evidence of the pledge, including, for example, in the case of real property, title insurance showing the interest of the collateral agent or security trustee and a legal opinion (addressed to Standard & Poor's) stating that the collateral agent or security trustee has a first perfected security interest in all other collateral in which a security interest can be perfected, either by possession or filing, or at common law. If the subsidiary is unwilling or unable to pledge its assets, reduced credit may be given for the parent's pledge of its ownership interest in the subsidiary.

Regulatory Supervision.

Transactions involving electric, water, natural gas, and telephone utilities may be subject to regulatory supervision. In the context of the weak-parent/strong-subsidiary linkage, the utility usually represents the strong subsidiary. Regulatory approval, influence, or mandate may well have a positive effect on credit quality. The effect of regulation is felt minimally when the subsidiary must secure regulatory approval to sell debt or dividend cash to the parent. Depending on particular circumstances, the rating differential created by such regulatory environment may be compounded by a package of structure, covenants, and collateral.

Multiple Ownership.

In circumstances where the subsidiary is controlled by at least two parents, or is the subject of a joint venture, the insolvency or financial difficulty of a particular venturer is less likely to have consequences for the credit quality of the subsidiary. The measure of control that a particular parent can exercise is usually related to the size of its ownership interest and the extent of its legal rights in the subsidiary. For this reason, the percentage of ownership is significant, but the identity and nature of any other owner is equally important in assessing its capabilities for effectively blocking an attempt by a co-owner to file the subsidiary. In general, where two or more parents are motivated and able to prevent each other from harming the credit quality of the subsidiary, the rating of the credit quality of the subsidiary may be higher than that of any parent's, if justified on a "stand-alone" basis. Moreover, the subsidiary may depend more heavily on one particular parent, in which case the subsidiary's rating may be affected by the dependency.

Conclusion

In the United States, there are a number of more or less traditional ways in which the credit quality of a subsidiary might be rated higher than the credit quality of its parent entity. In common-law jurisdictions such as the United Kingdom and Australia, there may be greater potential for differentiation. In all cases, the "package" of distancing mechanisms that serves as the basis for the rating differentiation should be an extensive one. Nevertheless, ratings benefits accruing to the subsidiary through the methods described above may come at a price: To the extent that the credit-quality rating of the subsidiary is elevated above the credit quality of the consolidated entity, the rating of the consolidated entity may be reduced. Finally, it cannot be overemphasized that the differentials achieved by true securitization will seldom be possible in a corporate transaction because of "single-asset" or enterprise risk, regardless of the structural and other features incorporated into the transaction.

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Exhibit LCG-3

FitchRatings

The Ripple Effect

Bankruptcies, Ring Fencing and Recoveries

Richard Hunter

15th Annual Fitch Global Power Breakfast

October 2003

Presentations

Exhibit LCG-3

Good Morning. I am really pleased to be here to talk about affiliate linkages and ring-fencing with you today.

Exhibit LCG-3

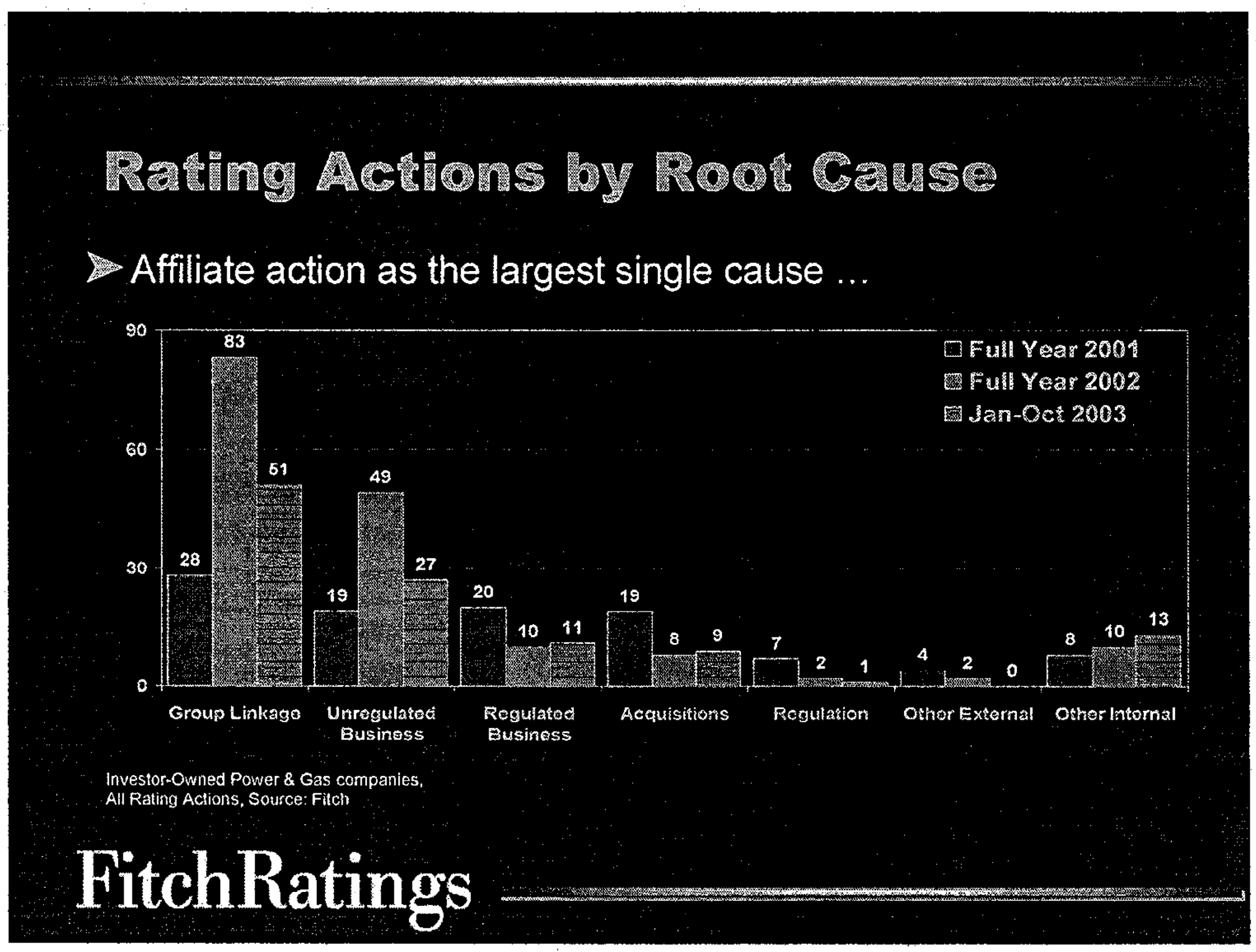
Discussion Topics

- What is the effect of affiliate business and financial linkages on credit ratings?
- How do effective ring-fencing mechanisms enable wider notching of ratings among related issuers within utility groups?

FitchRatings

Denise Furey has just discussed the external consequences of a bankruptcy on the bankrupt company's contractual counterparties. I will take an internal view and discuss the impact of a distressed or bankrupt subsidiary or parent company on the ratings of related entities within its utility group. I will be talking about the effects that business and financial linkages among related affiliates have on credit ratings and how effective ring-fencing mechanisms can enable wider notching of the issuer ratings within groups.

Exhibit LCG-3



As a backdrop, this chart shows rating actions by primary cause over the past few years. A rating action is defined as an upgrade, downgrade or change in rating watch status. As you can see, group linkage has been the single largest driver of rating changes. In 2002, group linkage caused 51% of all rating actions and year to date in 2003 was the reason behind 46% of all rating actions.

To explain how this slide works, have a look at the second group of bars, which is titled: Unregulated Business. If there is an unregulated subsidiary within a utility group, for example, a wholesale energy merchant, that experiences credit deterioration and has its rating downgraded as a result, and the parent company and the regulated utilities in the group are downgraded concurrently as a result of the unregulated subsidiary's downgrade, the parent and utility downgrades would fall into the group linkage bucket. Similarly, if the regulated utility was downgraded because it became over-levered or for whatever reason, that downgrade would be reflected in the third group of bars, Regulated Business, and any other utility or non-utility affiliates in the group that had their ratings dragged down too would be accounted for in the group linkage category.

If PUHCA is repealed, Fitch believes there will be a step-up in merger and acquisition activities. If the big utility groups do get bigger, then group linkage is expected to grow as a percentage of total rating actions.

Exhibit LCG-3

Effect of Ring-Fencing on Ratings

More Frequent	Corporate subsidiary with strong ring-fencing and no business linkage with parent	Fitch may rate subsidiary higher than parent, (two notches typical for IG, wider in speculative grades)
Less Frequent	Corporate subsidiary with substantial linkage and weak ring-fencing	Parent and subsidiary ratings are similar
Less Frequent	Securitization e.g. stranded costs, A/R securitization	Ratings of SPE are not constrained by parent or affiliate ratings

FitchRatings

So how can ring-fencing efforts help to limit group linkage contagion?

As shown in the first row, most of the utility groups rated by Fitch have fairly tight ring-fencing to separate affiliates and do not have substantial business or financial linkages. For investment grade utility groups that have effective business and financial separations in place, the most typical notching between the parent and lower risk utility subsidiary ratings is one to two notches. Non-regulated businesses that have higher business risk are typically rated lower than the parent company. Ratings of related issuers can widen out considerably in below investment grade categories if strong ring fencing is in place. Fitch's scrutiny of ring-fencing efforts increases for companies rated in below investment grade categories. As Rob Hornick mentioned earlier, there have been no substantive consolidations in utility bankruptcies to date, but affiliates nonetheless can suffer in many ways from an insolvent parent or affiliated entity.

The second row shows a less common situation in which ring-fencing measures are weak or completed negated by a material business linkage, such as a significant inter-company loan, centralized cash management and funding or a power supply contract. If this is the case, then ratings for the various issuers in the group will be the same or be very similar.

The last row shows the impact of a securitization. Propoerly structured through a bankruptcy remote special purpose entity, this is the only way to completely de-link and isolate an issuer's rating from those of others in its affiliated group.

Exhibit LCG-3

Rating Inter-Relationships

	Dec-00	Current	Change
Allegheny Energy	A	BB-	7
Monongahela Power	A+	BBB-	5
Allegheny Energy Supply	BBB+	B-	8
Southern Company	A	A	0
Georgia Power	A+	A+	0
Southern Power *	BBB+	BBB+	0
Enron Corp.	BBB+	D	16
Portland General	A+	BB	7
Dynegy Inc.	BBB	CCC+	8
Dynegy Holdings Inc.	BBB+	CCC+	9
Illinois Power	BBB+	CCC+	9

* New senior unsecured rating assigned 11/13/01

FitchRatings

Let's look at some specific companies as examples.

Allegheny Energy, the parent holding company of Allegheny Energy Supply, is an unregulated wholesale subsidiary that became troubled, as well as a number of regulated utilities, including Monongahela Power. The distance between the ratings of the issuers in the Allegheny group back in December 2000 was fairly typical in the investment grade category. There was one notch between the senior unsecured ratings of the parent company and the utility subsidiary, and 2 notches separating the ratings of the parent and the unregulated, higher risk subsidiary. Currently, the notching is wider. The utilities in the group have reasonable ring-fencing limits on upstream dividends and other financing restrictions. Also, the utility subsidiaries participate in a shared "money pool", but neither the parent nor the supply company can borrow from the pool.

The second example of rating differentials among related issuers is the Southern Co. Note the rating distribution: the parent rating is one notch below that of Georgia Power and two notches above the rating of Southern Power, which is a non-regulated generation subsidiary.

Enron and the Dynegy group illustrate opposite ends of the spectrum. Enron/Portland General Electric is an example of ring-fencing that works as well as can be hoped for in the event of the actual bankruptcy of the parent. Dynegy is an example of a company with affiliate linkages that are so great that there is no notching at all among the related issuers.

Portland General Ring-Fence

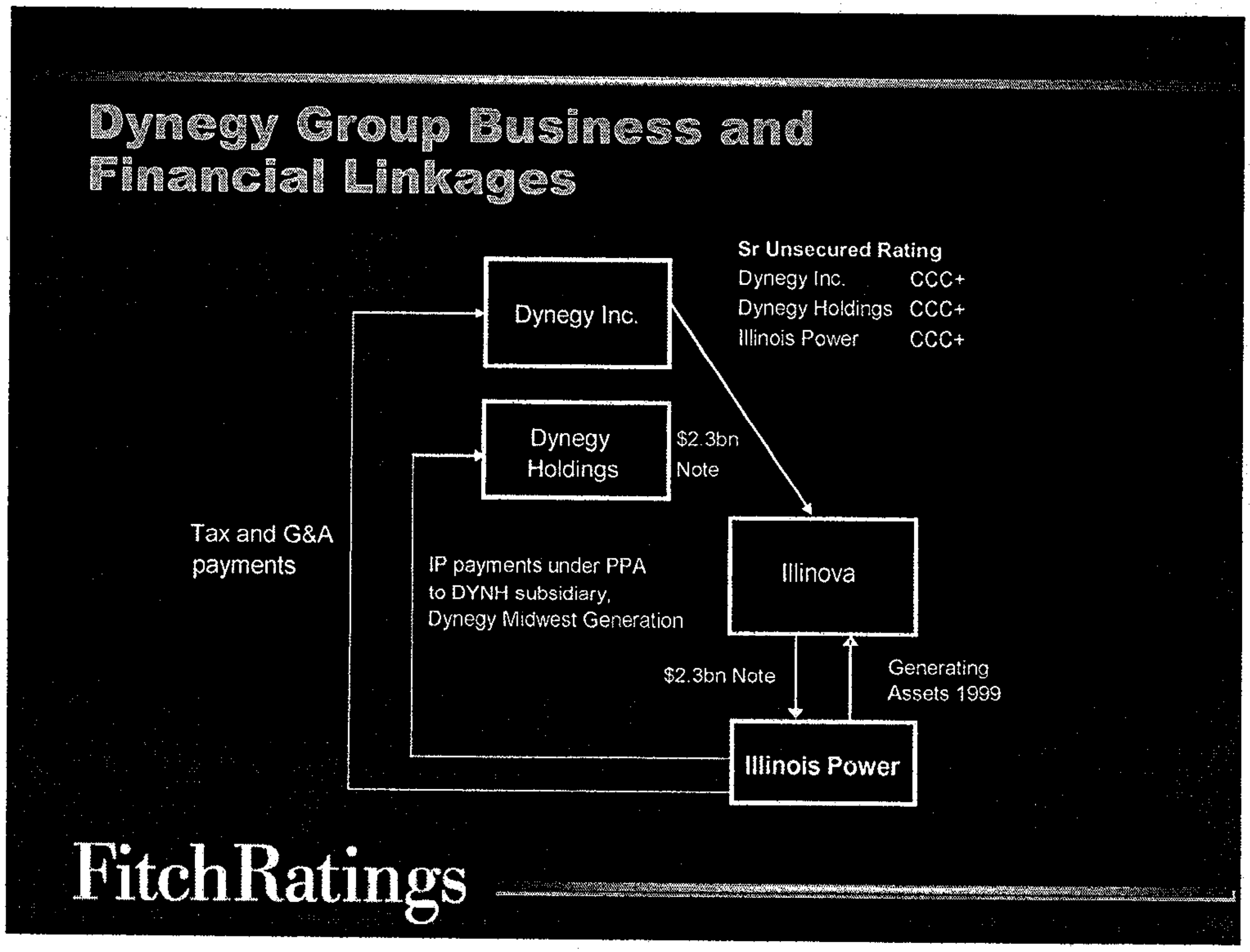
- Regulatory: OR PUC conditions to merger included - no upstream dividend payments if payment would cause debt to capital ratio to fall below 48%
- Contractual: R/C Limits on dividends
- Policy - Separate operations, separate books and records, separate officers
- Nevertheless, contagion happened

FitchRatings

In Fitch's view, Portland General Electric has an effective ring-fence. It has all three types of ring-fencing. Ring-fencing measures were put in place by regulators as conditions precedent to the Enron acquisition, contractually by creditors through its bank agreements, and by the company's own policies. The way we think about it is that the most effective ring-fences are made through the collective use of all of these types of ring-fencing measures.

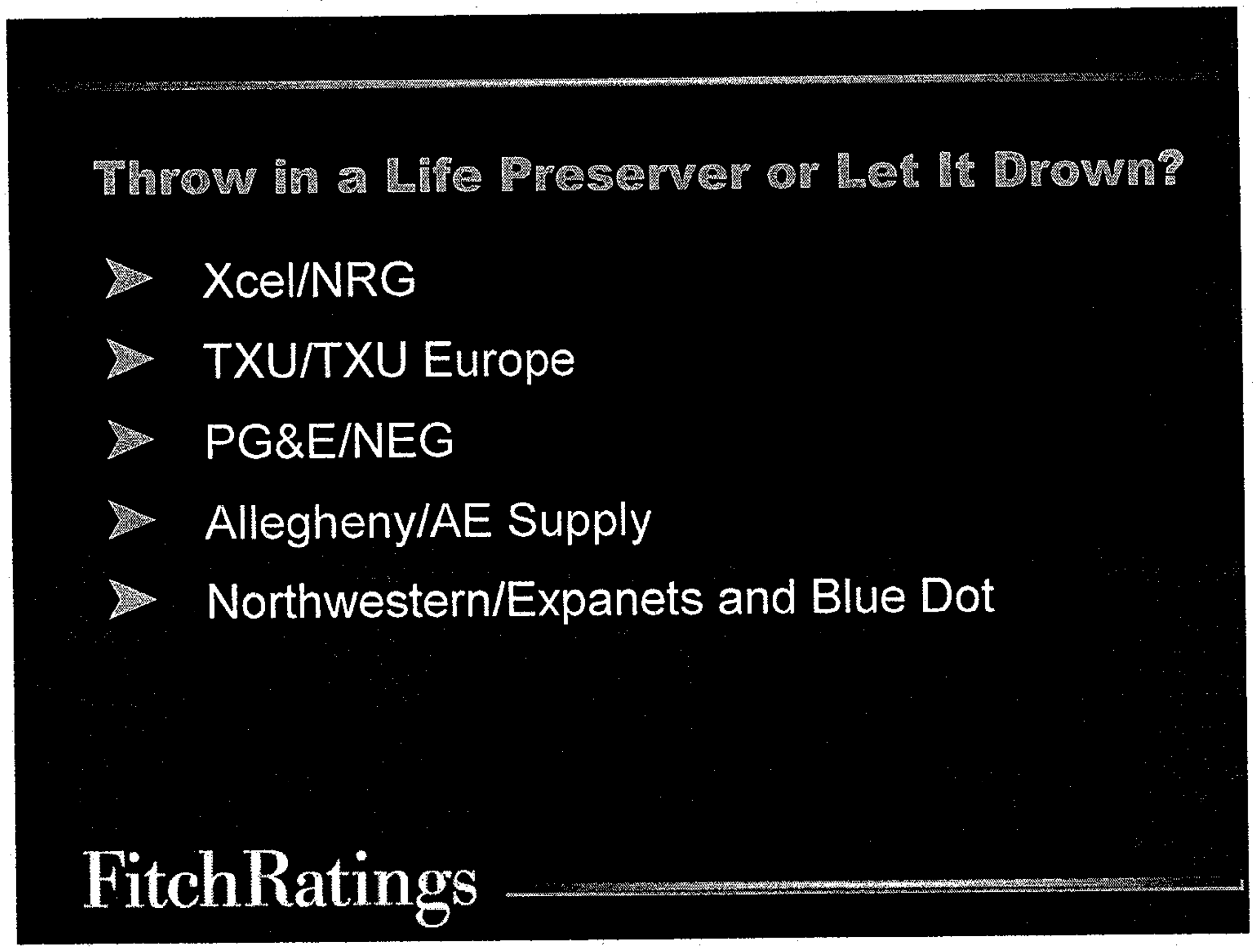
However, despite these efforts, when Enron filed, Portland General was adversely affected due to contagion from Enron. Although its financials were consistent with a strong investment grade issuer, Portland General was unable to access the CP markets or to borrow on an unsecured basis. Mainly as a result of this lack of capital market access, it was downgraded to the 'BB' category. A 'BB' rating does not imply a very high likelihood of default. The take-away lesson is that perfect ring-fences are impossible to construct, except through a securitization, because contagion happens.

Exhibit LCG-3



Dynegy is the opposite story. This rather complicated looking chart illustrates the business and financial linkages that exist among the affiliates. Illinois Power sold off its generation in 1999 and was paid in the form of an inter-company note. It receives debt service under this $2.3 billion inter-company note from its immediate parent, Illinova. Illinova, in turn receives debt service under another $2.3 billion note with similar terms from the ultimate parent, Dynegy Inc. Illinois Power makes tax and G&A payments to Dynegy in an amount basically adequate to cover the debt service on this note. Also, Illinois Power makes payments to a subsidiary of Dynegy Holding, Dynegy Midwest, under a Power Purchase Agreement. The financial linkages here are so great that all of the companies in the DYN family are rated the same.

Exhibit LLG-3



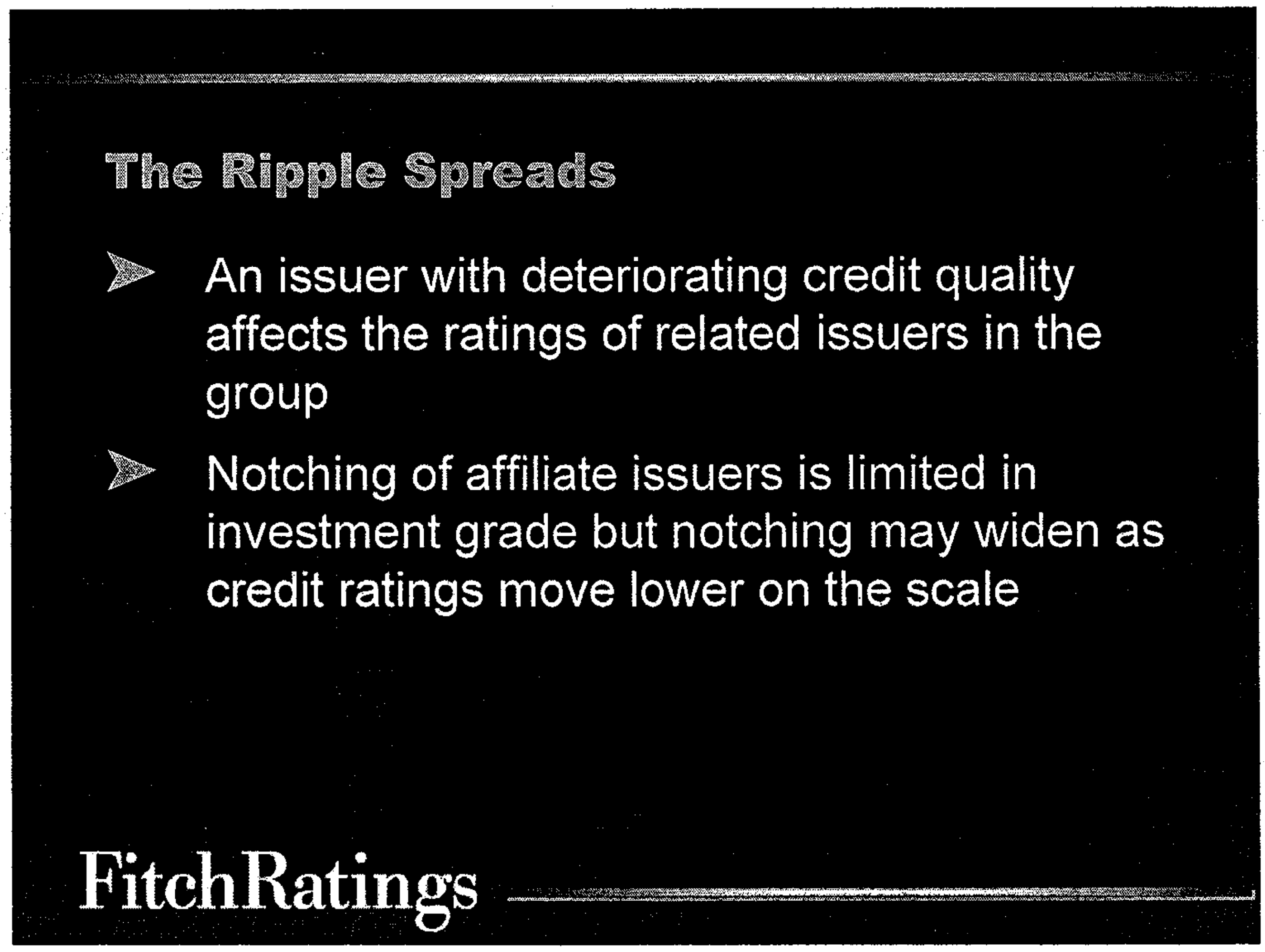
In keeping with this morning's aquatic theme, I've titled this slide, "Throw in a life preserver or let it drown?" All of these companies have or had troubled businesses and face or faced the decision whether to amputate that activity from the rest of the group.

First are Xcel and its bankrupt subsidiary, NRG. Xcel made a public statement that would invest a new capital infusion into NRG. Then Xcel changed its mind, but it was too late. Xcel negotiated a settlement to pay $752 million to the creditors of NRG to get them to drop future claims against Xcel.

The next example is TXU and TXU Europe. When the full extent of financial weakness at the European subsidiary became apparent and negotiations with tolling counterparties had hit a stalemate, TXU Corp. decided to put TXU Europe into administration.

While we don't have time to go through all five examples, the point is that a strategy to continue to support a weak subsidiary, or even statements of intention to support a poorly performing affiliate, may have important implications to the group.

Exhibit LLG-3



To wrap up, despite the best efforts to separate a utility from the rest of its group, contagion happens. An issuer with deteriorating credit quality will affect the ratings of the other issuers in the group.

With that, I will turn it over to my colleague, Ellen Lapson, who is going to talk about the outlook for the future of the wholesale power sector. Thanks very much for your attention.

Exhibit LCG-4

FitchRatings

Corporate Finance

Global Power/North America
Special Report

Rating Linkage Within U.S. Utility Groups

Utilities, Holding Companies and Affiliates

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Related Research
- Special Report: Rating Linkage Within European Utility Groups, April 9, 2003
- Credit Update: Illinois Power and Illinova Corp., March 27, 2003
- Credit Update: Westar Energy, March 17, 2003

■ Overview

Ring-fencing mechanisms are techniques employed to isolate credit risks of an issuer from the risks of affiliate issuers within its corporate group. Depending on the nature of the ring-fence methods employed, Fitch Ratings may evaluate various affiliated issuers as a single consolidated entity, as separate entities with distinct but related ratings, or, in special cases, as distinct entities (e.g., a special-purpose entity or an affiliate in a different sovereign jurisdiction). The maximum independence among affiliated issuers results from concurrent deployment of numerous ring-fencing methods.

The quality of a ring fence is an important determinant of notching, or ratings differential, among various issuers within a group. If strong ring-fencing mechanisms exist, wider notching is possible, especially in below-investment-grade rating categories.

In Fitch's view, ring-fencing techniques rarely provide total insulation of a U.S. utility from problems relating to an insolvent parent. Furthermore, even if affiliates are segregated in numerous ways, the presence of a single important unifier, such as a large intercompany loan or an intercompany supply contract critical to continuing operations, may nullify all other ring-fencing efforts.

In evaluating the effectiveness of ring-fencing tactics, there is a limitation in the small number of bankruptcies in the past three decades involving U.S. utilities available as precedents, and few of the precedent cases involved companies within holding company groups. That being said, Fitch is not aware of any cases in recent decades of the consolidation of a U.S. utility along with its holding company parent or affiliates in bankruptcy.

Nonregulated businesses within many U.S. utility groups along with credit stresses stemming from industry regulatory changes make ring fencing particularly important for groups with a subinvestment-grade parent or one or more speculative issuers, as these issuers are closer to an event of default, which would put corporate separation to the test in any resulting bankruptcies.

■ Regulatory Ring-Fencing Mechanisms

Restrictions imposed by state and federal authorities can be valuable sources of ring-fencing protection for regulated utilities. Utilities are subject to state regulation in each state of operation. Depending on the applicable state(s) regulatory framework, as well as the company's organizational structure and geographic reach, utilities may also fall under one or two federal regulatory jurisdictions. Federal regulators are the Securities and Exchange Commission (SEC), through powers vested by the Public Utilities Holding Company Act of 1935 (PUHCA), and the Federal Energy Regulatory Commission (FERC), via the Federal Power Act of 1920 (FPA). Each utility's unique regulatory relationships and constraints are considered on a case-by-case basis. Holding companies (holdcos) engaged through subsidiaries in more than one state in the electric utility business or in the retail distribution of natural gas are subject to regulation under PUHCA. PUHCA is intended to limit abuses by holdcos and prevent cross-subsidization of nonregulated businesses by regulated entities. Holdcos are regulated on matters including company structure, intercompany loans, reporting, acquisitions and issuance and sale of securities. There are currently 28 ultimate holdcos subject to PUHCA, of which two, Allegheny Energy, Inc. (Allegheny Energy) and Xcel Energy, Inc. (Xcel), are rated below investment grade. The positive effect of PUHCA regulations on the credit quality of subject utilities is illustrated by the case of Xcel. Fitch rates four of Xcel's regulated utility subsidiaries' senior unsecured debt 'BBB', despite the insolvent status of its NRG Energy, Inc. (NRG) merchant energy affiliate and Fitch's 'BB+' senior unsecured rating of Xcel. However, the protections offered by regulation under PUHCA do not entirely disconnect the ratings of utility subsidiaries from those of the parent holding companies, and Xcel's subsidiaries' ratings are lowered by the stress affecting Xcel and affiliate NRG.

Utilities engaged in interstate wholesale electricity transactions may be subject to FERC regulation. In response to investor concerns, the FERC recently issued new policies regarding debt issuances by public utilities (FERC Docket ES02-51-000, issued Feb. 21, 2003). The new policies indicate a newfound FERC focus on restricting use of utility assets for nonutility purposes, but the effect of practical implementation remains to be seen given the limited scope of FERC jurisdiction over utilities' securities issuance. FERC regulates securities issuance only when not regulated directly by PUHCA or state regulations.

States, through state public service commissions (PUCs) and state law, impose restrictions on regulated utilities to protect the public interest and maintain credit quality. Regulators in different states have varying amounts of authority under law, and in some cases, state regulators have not exercised the authority available to them. PUCs often seem to become more active in exercising authority when credit quality falls below investment grade and after the company's financial integrity has already been impaired. For example, the Kansas Corporation Commission recently ordered Westar Energy, Inc. (Westar) to separate its Kansas Power & Light utility division from the holding company in order to protect ratepayers from liabilities related to nonregulated activities. In certain states, laws governing utilities provide more significant protection to utility consumers and, indirectly, to utility creditors. For instance, under Indiana state law, the directors of the board of a regulated utility may be held personally liable for the amount of dividends upstreamed to the parent company in excess of the fair market value of net equity.

■ Other Financial Constraints

Financial restrictions can help to isolate credit risks of regulated and nonregulated issuers within a group. Efficacy of financial restrictions is enhanced if there are clear-cut penalties for violations and regular compliance reporting requirements. Examples of such penalties are the trigger of an event of default under a bank credit agreement or trading agreement, or financial penalties that may be imposed by a PUC. During the rating process, Fitch evaluates the magnitude of any existing intercompany financial supports. Additionally, the extent of legal, regulatory, contractual and corporate policy protections of a financial nature against scrambling the finances of regulated and nonregulated affiliate issuers are considered, and when such limitations exist, Fitch reviews and evaluates the details.

Financial restrictions imposed solely through internal corporate policies are a weaker method of isolating issuer risks relative to those mandated by law, regulation or contract because the corporation may adjust its policies at will. Nevertheless, corporate policies are helpful indicators of management intent. While there are cases in which a financially stressed parent has extracted dividends, intercompany loans or assets from its regulated utility subsidiaries, there are numerous cases illustrating voluntary restraint by a financially stressed parent holding company. Xcel and Allegheny Energy are two recent examples of holding companies that have refrained from transactions that impair the financial condition of their utility subsidiaries.

Exhibit LCG-4

Large intercompany financial transactions or supports can cancel out the benefits of other ring-fencing efforts. For example, the senior unsecured ratings of each issuer in the Dynegy group are closely linked because the issuers' finances and operations are intertwined due to a $2.3 billion intercompany note and structural and functional ties among the entities. Illinois Power Co. (IP) relies on payments under the $2.3 billion note receivable from Illinova Corp. (ILN) for a material portion of its operating cash flows. This loan originally compensated IP for the transfer of its generating assets to a subsidiary of ILN that eventually became a subsidiary of Dynegy Holdings when ILN was purchased in 1999. Through another intercompany note with similar terms, Dynegy Inc. makes payments to ILN to support its obligations to the utility, and thus payments to IP depend on Dynegy. As a result, there is no notching among the senior unsecured ratings in the Dynegy group.

■ Related-Party Business Linkage

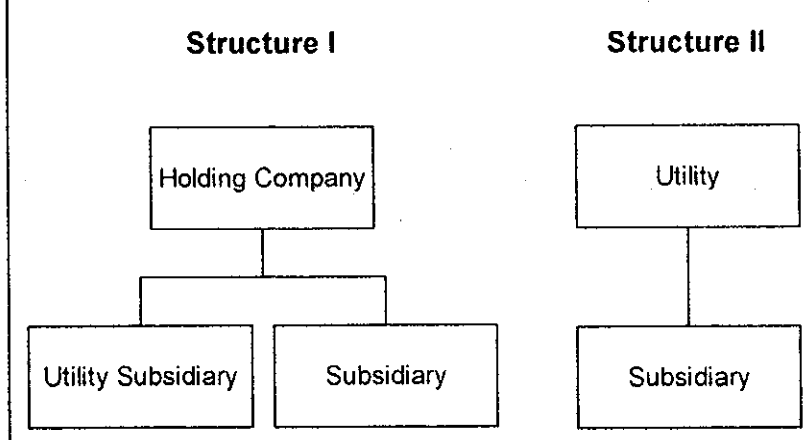
Related-party business transactions such as supply arrangements are an important factor in Fitch's ring-fencing assessment. If a linkage between a regulated utility and a nonregulated affiliate is critical to the continuing operations of the entities and difficult to replace by an independent third party, then narrower rating differentials between the regulated and nonregulated issuers' ratings are likely. Conversely, if transactions are done at arms length, using market prices with the ability to replace counterparties under defined distress scenarios, the degree of separation between related issuers' ratings may be increased.

■ Organizational and Operational Factors

An evaluation of a group's organizational structure helps determine whether related issuers are deemed to have a consolidated risk of default or distinct credit profiles. There are two types of utility holding company structures, shell holding companies and utility operating companies acting as the holding company for non-regulated subsidiaries. (See organization charts above.)

A nonregulated shell holding company, which owns the equity of both regulated and nonregulated subsidiaries, is the more common of the two types. Below-investment-grade companies structured this way include TNP Enterprises, Allegheny Energy, Xcel, and IPALCO (a subsidiary of AES Corp.). The holding company structure aids in the construction of a strong ring fence.

Typical Utility Organizational Structures



In a less common structure, the regulated utility operates as a division of the parent company, as is the case with Westar, Duke Energy Corp and Aquila, Inc. Duke Energy Corp. is currently the only utility rated in the investment grade that follows this pattern. This structure generally results in a higher risk profile for the utility if higher risk nonregulated businesses are owned through subsidiaries or operated within the holding company. If nonregulated businesses have speculative credit profiles, the lack of separation results in utility ratepayers and creditors sharing the risk. As noted previously on page 2, Westar was ordered by the Kansas Corporation Commission (KCC) to separate its Kansas Power & Light division from the holding company. Post-separation, the KCC has limited total debt at Westar's two Kansas utilities to no greater than $1.67 billion, which will leave the parent with significant debt. The KCC issued this order to prevent interaffiliate accounting practices and relations that are harmful to public utility business; to protect ratepayers from the risks of non-utility business ventures in the corporate family, and to reduce utility debt accumulated for non-utility purposes.

The potential weakness of the second structure is further illustrated in the case of Reliant Energy, Inc., a company formerly structured in this manner, with a regulated Houston-based electric utility as parent to a large diversified group with merchant energy activities. Recently, the merchant generation and energy marketing subsidiary was spun out as an independent company, Reliant Resources, Inc. (RRI). The former Reliant Energy, Inc. (renamed CenterPoint Energy Houston Electric, LLC) became a subsidiary of a new holding company, CenterPoint Energy Inc. Despite the new corporate structure, Houston Electric LLC retains legal exposure for contingent liabilities that may arise relating to its former subsidiary, RRI. A sub-investment-grade

Exhibit LCG-4

merchant energy company, RRI has indemnified CenterPoint for any potential costs relating to pre-separation liabilities

Separation of management, boards, bank accounts and books and records are important for an effective separation of risk. During the rating process, Fitch will review a group's structural organization by checking if affiliates have operating or management linkages.

In summary, regulatory, financial, structural and operational ring-fencing techniques help reduce the credit risk of an issuer stemming from financial problems of related issuers. Fitch evaluates the nature and the significance of the ring-fencing methods employed to determine the likelihood that the bankruptcy of a single issuer within a group will precipitate a bankruptcy filing by affiliate issuers and result in a substantive consolidation in bankruptcy.

Examples of Notching Differentials for Groups in the Speculative Grade

Holding Companies (Senior Unsecured Ratings)	Regulated Subsidiaries	Senior Unsecured Rating	Differential in Notches
BB+			
TNP Enterprises, Inc.	Texas-New Mexico Power Company	'BBB–'	1
Xcel Energy Inc.	Northern States Power Co. (MN)	'BBB'	2
	Northern States Power Co. (WI)	'BBB'	2
	Public Service Co. of Colorado	'BBB'	2
	Southwestern Public Service Co.	'BBB'	2
BB–			
Westar Energy, Inc.*	Kansas Gas and Electric Co.	'BB–'	0
B+			
CMS Energy Corp.	Consumers Energy Co.	'BB+'	3
	Panhandle Eastern Pipeline Co.	'BB'	2
Aquila, Inc.	N.A.**	N.A.	N.A.
Allegheny Energy, Inc..	Monongahela Power Co..	'BB'	2
	The Potomac Edison Co.	'BB'	2
	West Penn Power Co.	'BB+'	3
B			
The AES Corporation	Indianapolis Power & Light Co.	'BB+'	4
Edison International	Southern California Edison Co.	'BB–'	2
CCC+			
Dynegy, Inc.	Illinois Power Co.	'CCC+'	0
D			
Enron Corporation	Portland General Electric Co.	'BB–'	9
	Transwestern Pipeline Co.	'B+'	8

*Kansas Power & Light Co. is a regulated utility operating as a division of Westar Energy, Inc. **Regulated utilities are operated as divisions of Aquila, Inc., and are rated 'B+'. N.A. – Not Available

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August 12, 2008

Summary:

Delmarva Power & Light Co.

Primary Credit Analyst:
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Summary:
Delmarva Power & Light Co.

Credit Rating: BBB/Stable/A-2

Rationale

The ratings on Delmarva Power & Light Co. (DPL) are based on the consolidated rating on its parent, Pepco Holdings Inc. (PHI), a diversified energy company. The ratings on PHI and its subsidiaries reflect the consolidated credit profile of its regulated and unregulated businesses: DPL, Atlantic City Electric Co., and Potomac Electric Power Co., Conectiv Energy Holding Co. (merchant generation), Pepco Energy Services (energy marketing), and Potomac Capital Investment Corp. (PCI; a portfolio of SILO transactions). Washington, D.C.-based PHI and its subsidiaries had $5.4 billion in debt outstanding as of June 30, 2008, including securitized transition bonds of ACE.

DPL supports the rating on PHI by contributing approximately 20% of PHI's consolidated cash flow and providing PHI with a growing base of residential and commercial customers. PHI's business risk profile is considered strong after incorporating the excellent business profiles of the rated utilities and the company's more risky unregulated operations. The utilities contribute about 65% of PHI's consolidated cash flow and may continue contributing about this level for the foreseeable future. Some of the utilities' strengths include increasing energy use by residential and commercial customers, economically-healthy service territories, and the absence of significant generation-related operating risk. We consider the unregulated businesses significantly more risky than the utilities due to their exposure to volatile commodity prices and very competitive retail energy markets. These risks are partially mitigated by the company's strategy to hedge a majority of its capacity over a two- to three-year period. PHI has reduced the risk profile of its unregulated financial services operation by selling many of PCI's non-energy investments, but the business remains exposed to IRS challenges regarding the tax deductibility of SILO transactions.

The ratings incorporate a consolidated financial profile that we consider as aggressive. After adjustments for operating leases, securitized debt, retirement obligations, and asset retirement obligations, funds from operations (FFO) to total debt was 11.8% as of June 30, 2008. Adjusted FFO interest coverage increased to 3.1x as of June 30, 2008, from 2.8x at the end of 2007. Debt leverage was57%, slightly less than the 59% as of year-end 2007. Adjusted net cash flow to capital expenditures was 69%, implying capital expenditures were significantly greater than internally generated cash flow after dividend payments.

Short-term credit factors

The short-term ratings for DPL and PHI are 'A-2' and reflect Standard & Poor's expectation that PHI will retain an adequate level of available capacity under its credit facilities for its liquidity requirements and any cash payments resulting from collateral calls. Standard & Poor's expects that PHI utilities will continue to generate stable cash flow, and given the stable nature of the majority of cash flows, PHI's and its subsidiaries' liquidity is adequate.

As of June 30, 2008, PHI had $291 million of cash and cash equivalents. In addition, PHI has a $1.5 billion credit facility agreement that matures in May 2012 and that is available to PHI and its utilities with sub-limits. PHI can draw $875 million, and its utilities can draw up to $500 million each with a $625 million total limit. The credit facility primarily backs up the $1.5 billion commercial paper program that as of June 30, 2008, had $107 million

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outstanding. In addition, PHI had $134 million of variable rate demand notes outstanding.

Outlook

The stable outlook on PHI and its subsidiaries reflects Standard & Poor's expectation for modest improvement of currently weak financial measures. The outlook could be revised to negative if financial measures weaken significantly during the pending construction phase or due to any material adverse outcomes regarding various pending issues such as IRS challenges. Although unlikely, if financial measures significantly strengthen, the outlook could be revised to positive.

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August 6, 2009

Summary:
Delmarva Power & Light Co.

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Summary:
Delmarva Power & Light Co.

Credit Rating: BBB/Stable/A-2

Rationale

The ratings on Delmarva Power & Light Co. (DPL) are based on the consolidated rating on diversified energy company PEPCO Holdings Inc. (PHI) and the consolidated credit profile of its regulated and unregulated businesses: DPL, Atlantic City Electric Co. (ACE), and Potomac Electric Power Co., Conectiv Energy Holding Co. (merchant generation), Pepco Energy Services Inc. (energy marketing), and a portfolio of SILO transactions. Washington, D.C.-based PHI and its subsidiaries had $6.2 billion in outstanding debt (DPL comprises $930 million) including ACE's $400 million of securitized transition bonds.

DPL supports the rating on PHI by contributing approximately 20% of PHI's consolidated cash flow in 2008 and providing PHI with a growing base of residential and commercial customers. PHI's business risk profile is considered strong after incorporating the excellent business profiles of the rated utilities, including DPL, and the company's more risky unregulated operations. The utilities contribute 65% to 70% of PHI's consolidated cash flow and management expects the utilities to continue contributing around this level for the foreseeable future. Strengths of the utilities include increasing energy use by residential and commercial customers and the absence of significant generation-related operating risk. Over the next several years, PHI is pursuing two utility initiatives: the Mid-Atlantic Power Pathway transmission project that may cost about $1.2 billion and the installation of advanced metering within its utilities' service territories that could cost $425 million.

We consider the unregulated businesses significantly more risky than the utilities due to their exposure to volatile commodity prices and very competitive energy markets. These risks are partly mitigated by the company's strategy to hedge a majority of its capacity over a two- to three-year period. Commodity risk continues to be managed in a 50%-100% range for the next 12 months and 25%-75% for months 13-24, and up to 50% for months 25-36. PHI's strategy for PES is shifting to contracting services such as energy efficiency and renewable energy and away from retail energy supply. Currently, PHI is conducting a strategic review of the energy supply operation and to reduce collateral obligations, the company arranged a credit intermediation agreement for certain power supply contracts. The leveraged lease portfolio continues to expose PHI to IRS challenges regarding the tax deductibility of these cross-border leasing transactions.

DPL's financial risk profile reflects that of the consolidated profile, which we consider significant and includes adjusted financial measures that, although they have declined from the end of 2008, remain in line for the rating. In addition, our expectation is that financial measures, although weak for the financial profile, will strengthen as capital investments are reflected in revenues. For 12 months ended March 31, 2009, funds from operations (FFO) interest coverage was 4x, FFO to total debt was 15.4%, and total debt to total capital was about 63%. Net cash flow (FFO post dividends) to capital expenditures was at a manageable level of 98% and the dividend payout ratio was 92%. Although debt to EBITDA weakened to 6.5x from year-end when it was 5.8x, this reflected both increased debt and lower EBITDA.

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Short-term credit factors

The short-term rating for DPL is 'A-2', the same as PHI. It reflects Standard & Poor's expectation that PHI will retain an adequate level of availability under its credit facilities for liquidity requirements and any cash collateral calls. As of March 31, 2009, PHI had $538 million of cash and about $1.2 billion of availability under two credit facilities. PHI has a $1.5 billion credit facility agreement that primarily backs up a $1.5 billion commercial paper program. This facility matures in May 2012 and is available to both PHI and its utilities with sub-limits. PHI can draw $875 million, and its utilities can draw up to $500 million each with a $625 million total limit. PHI also has a $400 million facility that matures in November 2009. Availability was $1.2 billion after reflecting $250 million of borrowings under the credit facilities, $140 million of outstanding CP, and $305 million of LCs. The operations of CEH and PES can expose the consolidated entity to unpredictable and greater-than-expected collateral calls. The credit intermediation agreement helped free up availability under the credit facilities after reductions in outstanding LCs. More recently, the company has maintained sufficient liquidity to address potential collateral calls under a stressed scenario comprised of a negative credit event and an adverse movement in commodity prices.

Outlook

The stable outlooks on DPL and PHI reflect our expectation for modest improvement in financial measures. The outlook could be revised to negative or the ratings could be lowered if the company concludes that it will continue operating in the retail marketing business or financial measures do not strengthen with greater operating cash flows or reduced debt leverage. We expect that the company's construction program will be prudently financed and any significant adverse outcomes regarding the IRS challenges to the company's leveraged lease portfolio will be addressed in a credit supportive manner. Although unlikely, if financial measures significantly strengthen and remain at more robust levels, the outlook could be revised to positive.

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Exhibit L2G-7

2009 Industry Challenges

PHI Pepco Holdings, Inc

- Significant infrastructure investments needed
- Lower customer usage due to economic conditions and conservation
- Higher operating costs (pension/bad debt)
- Commodity price volatility
- Uncertain and volatile debt/equity markets

PHI's Response: ***Remain flexible, routinely assess the situation, proceed with utility investments based on clear regulatory support***

Exhibit LCG-7

We anticipated and managed the challenges…

PHI Pepco Holdings, Inc

- **Accelerated the issuance of $750 million of First Mortgage Bonds and $225 million of equity to the 4th quarter of last year**
- **Focused on reducing overall spending**
  - Hiring freeze in place since Sept.; no management merit salary increases in 2009
  - Reduced Power Delivery construction spending in 2008, 2009, and 2010 by $129 million, $229 million, and $178 million, respectively
- **Developed a construction plan that is flexible to meet uncertain market conditions and regulatory outcomes**
- **Reducing the collateral needs of the competitive energy businesses**
- **Positioned to file four distribution rate cases in 2009**
  - Represents almost 70% of our distribution rate base
- **Pursuing federal incentive programs to lower construction financing costs and fund a portion of our energy efficiency programs**

Actions taken to date will enable us to fund our 2009 plan without accessing the capital markets